

FREE ELECTRONIC FILING AND NATIONAL TAXPAYER ADVOCATE ANNUAL REPORT

HEARING BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES ONE HUNDRED EIGHTH CONGRESS

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FREE ELECTRONIC FILING AND NATIONAL TAXPAYER ADVOCATE ANNUAL REPORT

THURSDAY, FEBRUARY 13, 2003

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to notice, at 3:00 p.m., in room 1100 Longworth House Office Building, Hon. Amo Houghton (Chairman of the Subcommittee) presiding.
[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
February 06, 2003
No. OV-1

CONTACT: (202) 225-1721

Houghton Announces Hearing on Free Electronic Filing and National Taxpayer Advocate Annual Report

Congressman Amo Houghton (R-NY), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on Free Electronic Filing and the recently issued Annual Report of the National Taxpayer Advocate. **The hearing will take place on Thursday, February 13, 2003, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 3:00 p.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. Witnesses will include Internal Revenue Service (IRS) Acting Commissioner Robert Wenzel, the National Taxpayer Advocate Nina Olson, Electronic Tax Administration Director Terence Lutes, and Electronic Tax Administration Advisory Committee Chairman Kevin Belden. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

BACKGROUND:

The Subcommittee will hold a hearing to evaluate the legislative recommendations of the National Taxpayer Advocate and the leading problems faced by taxpayers, as described in the Taxpayer Advocate's Annual Report. In addition, the Subcommittee will hear testimony from IRS officials concerning the IRS Free Filing initiative. Free Filing, a partnership with the private sector consortium of electronic tax preparers is designed to increase the number of taxpayers filing electronically.

In announcing the hearing, Chairman Houghton said: "We will hear about the new initiative that allows more taxpayers to file their taxes for free over the Internet. This will substantially increase the number of people filing their taxes electronically—benefiting taxpayers and the IRS. I also look forward to a discussing ways to improve our tax laws and streamline the functioning of the IRS with Nina Olson, National Tax Payer Advocate."

FOCUS OF THE HEARING:

The hearing will focus on the IRS Free Filing initiative, electronic tax administration, and the National Taxpayer Advocate's annual report.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Please Note: Due to the change in House mail policy, any person or organization wishing to submit a written statement for the printed record of the hearing should send it electronically to hearingclerks.waysandmeans@mail.house.gov, along with a fax copy to (202) 225-2610, by the close of business, Thursday, February 27, 2003. Those filing written statements who wish to have their statements distributed to

the press and interested public at the hearing should deliver their 200 copies to the Subcommittee on Oversight in room 1136 Longworth House Office Building, in an open and searchable package 48 hours before the hearing. The U.S. Capitol Police will refuse sealed-packaged deliveries to all House Office Buildings.

Note: All Committee advisories and news releases are available on the World Wide Web at <http://waysandmeans.house.gov>.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman HOUGHTON. The hearing will come to order. Good afternoon everybody, and we are delighted that you are here. I am flanked by two very distinguished people—not franked—and we are going to learn about an innovative agreement that the Internal Revenue Service (IRS) has entered into with the private sector to bring free electronic filing to millions of taxpayers this year, the Free File Initiative, and I want to believe that both government and taxpayers are going to benefit. Many taxpayers will no longer have to pay an average of \$12.50 per return to e-file, and they will receive tax refunds on an average of 14 days instead of 4 to 6 weeks. The government is going to benefit from reduced errors in processing costs. Last year, 47 million taxpayers filed their tax returns electronically, and the initiative should lead to many millions of additional e-filed returns.

So, before us today on our first panel is one of America's most dedicated public servants, Bob Wenzel, who is now the Acting Commissioner of the IRS. Mr. Wenzel was nearing what he thought was the end of a 35-year career with the IRS when the outgoing Commissioner, Charles Rossotti, asked him to reconsider his retirement plans and twisted his arm a little bit. So, to his credit and to our great benefit, Mr. Wenzel took up Mr. Rossotti's offer and served an additional 5 years as Deputy Commissioner. It has now been over 40 years since Bob Wenzel first joined the IRS. Few individuals can point to such a long and distinguished career in public service. He is a great example for us all.

Now, also on our agenda is a review of the National Taxpayer Advocate's (NTAs) annual report to Congress. As was the case last year, Nina Olson's report is an excellent and invaluable resource, and due to the leadership of Ms. Olson and her predecessors, the Taxpayer Advocate has become the tax system's most effective guarantor of taxpayer procedural rights. She has brought us a number of thoughtful recommendations that we are going to review today.

So, now I would like to yield to a good friend of mine, the new Subcommittee Ranking Member and the best-looking Ranking Member we have had in many years since Mr. Pickle, Mr. Pomeroy of North by-God Dakota.

[The opening statement of Chairman Houghton follows:]

Opening Statement of the Honorable Amo Houghton, a Representative in Congress from the State of New York, and Chairman, Subcommittee on Oversight

Good afternoon. Today we are going to learn about an innovative agreement that the IRS has entered into with the private sector to bring free electronic filing to millions of taxpayers this year: the "Free File" Initiative. Both government and taxpayers will benefit. Many taxpayers will no longer have to pay an average of \$12.50 per return to e-file and they will receive tax refunds in an average of 14 days, instead of four to six weeks. The government will benefit from reduced errors and processing costs. Last year, 47 million taxpayers filed their tax returns electronically, and the Initiative should lead to millions of additional e-filed returns.

Before us today on our first panel is one of America's most dedicated public servants, Bob Wenzel, who is now the Acting Commissioner of the IRS. Mr. Wenzel was nearing what he thought was the end of a thirty-five year career with the IRS when incoming Commissioner Charles Rossotti asked him to reconsider his retirement plans. To his credit—and to our great benefit—Mr. Wenzel took up Mr. Rossotti's offer and served an additional 5 years as Deputy Commissioner. It has now been over 40 years since Bob Wenzel first joined the IRS. Few individuals can point to such a long and distinguished career in public service. He is truly an example for us all.

Also on our agenda is a review of the National Taxpayer Advocate's Annual Report to Congress. As was the case last year, Nina Olson's report is an excellent and invaluable resource. Due to the leadership of Ms. Olson and her predecessors, the Taxpayer Advocate has become the tax system's most effective guarantor of taxpayer procedural rights. She has brought us a number of very thoughtful recommendations that we will review today.

I would now like to yield to a good friend of mine, the Subcommittee's Ranking Member, Mr. Pomeroy from North Dakota.

Mr. POMEROY. Mr. Chairman, I am overcome by an introduction of that nature. I want to congratulate you as you begin another year as Chairman of this Subcommittee on Oversight, and your agenda for the very first meeting, I think, is consistent with the leadership you have brought to oversight using the powers of this Subcommittee to explore how we can improve the Tax Code, how we can make it easier for individual tax filers, and how we can capture their feedback through the Taxpayer Advocate position, always working to improve the Tax Code, make it more fair and easier to comply with for the taxpayers of this country.

I know of your own interest, Mr. Chairman, in tax simplification, and in a place where there are often many partisan issues that divide us, this ought to be our overarching topic that unites us, and I am very much looking forward to participating in bipartisan initiatives with you as we seek to improve the Tax Code.

I appreciate your recognition of Mr. Wenzel in light of the long and illustrious career he has offered on behalf of all of us. Congratulations to you, and it is a capstone achievement to serve as Acting Commissioner. Have you had that opportunity in the past, Mr. Wenzel?

Mr. WENZEL. First time.

Mr. POMEROY. Well, it is a very appropriate capstone on a career of great public distinction, and we appreciate your efforts. With that, let's hear from our witnesses, Mr. Chairman.

[The opening statement of Mr. Pomeroy follows:]

**Opening Statement of the Honorable Earl Pomeroy, a Representative in
Congress from the State of North Dakota**

I am honored to have been elected as the Ranking Member on the Ways and Means Oversight Subcommittee. Working with Chairman Houghton, on a bipartisan basis, we will monitor the tax, health, Social Security, trade and human resource issues within the Committee's jurisdiction. This is a challenge I proudly accept.

It is appropriate that our first hearing of the 108th Congress focus on the Internal Revenue Service. Clearly, the IRS must administer our tax laws in a fair and efficient manner and the Subcommittee is responsible for overseeing its operation. I look forward to today's discussion of the IRS' new tax return "Free File Program" and the Taxpayer Advocate's annual report to the Congress.

The Free File Program is designed to provide low-income taxpayers with a no-cost way to prepare and electronically transmit their tax returns to the IRS. I support this initiative which is new for the 2003 tax return filing season. As we proceed, I want to make sure that taxpayers have easy access to the Free File Program and that the initiative works as intended.

Finally, I am pleased to receive the Taxpayer Advocate's Annual Report on IRS operations. I look forward to working with the Subcommittee to address the issues raised by this study. I am particularly interested in pursuing the legislative recommendation designed to better enable married couples, who own a farm or other small business, to file a simplified tax return. By simplifying the process of reporting, both spouses will be eligible for Social Security and Medicare benefits and avoid tax penalties for incorrect filings. I will continue to seek the assistance of my local Taxpayer Advocate from Fargo, North Dakota as the Subcommittee considers this issue.

I thank Chairman Houghton for scheduling this important hearing and look forward to the testimony of the hearing witnesses.

Chairman HOUGHTON. Thank you very much. Would you like to make an opening statement, Mr. Portman?

Mr. PORTMAN. Mr. Chairman, I appreciate just a very brief one to say I am very excited about the Free Filing initiative. The IRS Commission, which met for 2 years on the issues of how to reform the IRS, determined after a lot of research on the filing problems that it was far more effective and efficient to file electronically. In fact, we found that not only was it less than half the cost of filing by paper, but the error rate was so much less. At that time the error rate was 22 percent; 11 percent by the taxpayer, 11 percent by the IRS. The error rate with electronic filing was 1 percent or less. That alone has significant cost savings not just for the IRS, but also for the taxpayer the downstream costs were enormous. So, I am just delighted that after going back and forth on this issue for really the last 4 years, we finally have an understanding with the private sector that we will be able to offer free filing that covers 60 percent of all taxpayers.

This is a breakthrough, Mr. Chairman, and I think absolutely essential if we are going to come close to meeting our target, which is quite ambitious, of 80 percent of filers are filing electronically. We are now, I think, at about 36 or 37 percent. We will hear more about that.

I just wanted to commend the Service for finally working with the private sector, and commend the private sector folks who have been part of this in coming up with an arrangement which I think will be very helpful to meeting our shared goals. Thank you, Mr. Chairman.

Chairman HOUGHTON. Thank you very much. Ms. Tubbs Jones, would you like to make a statement?

Ms. TUBBS JONES. Well, I would like, thank you, Mr. Chairman. I would like—good afternoon. This is my first Subcommittee on Oversight hearing. I have managed to visit Health today, this afternoon, and I am serving on Social Security and Select Revenue Measures. I am glad to have an opportunity to meet you, Mr. Wenzel, and you, Mr. Lutes, as well; look forward to having an opportunity to get to know this process a little more. I get lots of IRS calls in my congressional office, so I will be glad to know who I can pick up the phone and call and get some results. So, thank you very, very much. Mr. Chairman, looking forward to serving with you, sir.

Chairman HOUGHTON. Thank you very much.

Mr. Kleczka.

Mr. KLECZKA. Mr. Chairman, I don't have any opening comment except to say it is good to be back to the Subcommittee on Oversight after an absence serving on the Committee on Budget, so, Mr. Chairman, you will have to put up with me for a couple of years.

Chairman HOUGHTON. Okay. That is great. Well, now I would like to call the first panel, who are already there. Mr. Robert Wenzel, who, as we said earlier, is the Acting Commissioner, and then Mr. Terry Lutes, who is Director of the Electronic Tax Administration (ETA) of the IRS. I don't think you are going to be giving any testimony, but you will be here; is that right, Mr. Lutes?

Mr. LUTES. Yes.

Chairman HOUGHTON. Okay. Mr. Acting Commissioner, the floor is yours.

STATEMENT OF THE HONORABLE ROBERT E. WENZEL, ACTING COMMISSIONER, INTERNAL REVENUE SERVICE, ACCOMPANIED BY TERRY LUTES, DIRECTOR, ELECTRONIC TAX ADMINISTRATION

Mr. WENZEL. Mr. Chairman and distinguished Members of the Subcommittee, thank you for this opportunity to discuss the joint IRS-private sector Free File Initiative. Also let me thank you, Mr. Chairman and Members of the Subcommittee, for your leadership and efforts to promote electronic filing and make it available to more taxpayers.

As you mention, accompanying me today is Mr. Terry Lutes, our IRS Director of Electronic Tax Administration.

As you know, the IRS Restructuring Reform Act of 1998 mandated that at least 80 percent of individual tax returns be filed electronically by the year 2007. We have certainly made progress toward that goal. Last year 35.6 percent of individual returns were e-filed, and this year we expect the number to climb to over 40 percent. Nevertheless, even with a 16-percent annual growth rate, the IRS would fall short of the 80-percent goal.

Now, to meet this ambitious objective, we must make it not only technologically possible, but also attractive for practitioners and taxpayers to make a permanent change to electronic filing. Cost to the taxpayer has been a barrier to further e-file growth. For years the IRS and the tax community would grapple with this issue and had very little success resolving it. That has changed dramatically with Free File.

Free File's roots can be found in the President's fiscal year 2002 management agenda, which championed e-government services. We were also guided by two principles; that is, no one should have to pay to file, and secondly, the IRS should not get into the software business. Through Free File, America's taxpayers can now access free online tax preparation and electronic filing services through irs.gov, or firstgov.gov. Free File will be available this year through April 15, and some companies will also offer free services through October 15 for taxpayers needing an extension.

The partnership agreement requires that the Alliance as a whole provide free tax preparation and filing to at least 60 percent of individual taxpayers, or approximately 78 million Americans. Many are taxpayers who prepare their own taxes and still file paper returns.

Initial Free File reports are very encouraging. As of February 5, Alliance Members have processed and transmitted almost 639,000 tax returns. This represents approximately 23 percent of the total 2.9-million-e-filed returns.

Mr. Chairman, we are also absolutely committed to protecting taxpayers privacy and confidentiality. Taxpayer information and data will be protected, and the Alliance members must adhere to IRS' strict privacy standards. We even required each participating company to obtain both a privacy and security seal certification.

We also took into consideration taxpayers who do not have access to a computer. Low income should never be a barrier to quality service, including free electronic filing. Free tax preparation and e-file are available in many communities at our Volunteer Income Tax Assistance and Tax Counseling for the Elderly sites. Volunteers there help prepare basic tax returns for low-income taxpayers, the disabled, the elderly and non-English speakers. Individual taxpayers with incomes of \$35,000 or less can also receive free income tax return preparation and e-file help at IRS tax assistance centers around the country. We extend this courtesy return preparation to all taxpayers also qualifying for the earned income tax credit (EITC).

Mr. Chairman, I also would like to stress that taxpayers are under no obligation to purchase any product from the software company or to use refund anticipation loans. Obtaining a fee-based product is a decision left to the individual taxpayer. The Internal Revenue Service as well as many of the Alliance company Web sites also reminds taxpayers that those who e-file and use direct deposit often receive their refunds in 10 days or less.

Mr. Chairman, in conclusion, Free File is a breakthrough for America's taxpayers. We are putting e-file within reach of millions more taxpayers and delivering on our President's commitment to put the needs of citizens first. This new program may be called Free File, but what it gives to millions of taxpayers and our government is invaluable. Thank you.

[The prepared statement of Mr. Wenzel follows:]

**Statement of the Honorable Robert E. Wenzel, Acting Commissioner,
Internal Revenue Service**

INTRODUCTION

Mr. Chairman, and distinguished Members of the Subcommittee, thank you for this opportunity to discuss the joint IRS-private sector "Free File" initiative. Accom-

panying me today is Mr. Terry Lutes, IRS' Director of Electronic Tax Administration.

Before I begin my formal testimony, let me thank you, Mr. Chairman, for your leadership and efforts to promote electronic filing and make it available to more taxpayers. Working closely with you, the Subcommittee, the Administration and the private sector, we are making steady progress to achieve congressionally mandated e-file goals and to provide service to taxpayers on a par with the very best private sector companies. Free File is a big step in that direction.

BACKGROUND

On January 16, 2003, the Treasury Department, the Office of Management and Budget (OMB) and the IRS launched a free on-line tax preparation and filing service called Free File. It was made possible through a partnership agreement between the IRS and the Free File Alliance, LLC—a private sector consortium of tax software companies. It could not have come a minute too soon.

The IRS Restructuring and Reform Act of 1998 (RRA 98) mandated that at least 80 percent of individual tax returns be filed electronically by 2007. Electronic filing's benefits are clear and compelling. Taxpayers and the IRS find it more convenient and economical and less time consuming to do business electronically rather than sending paper through the mail. Moreover, the government saves money, but the real benefits are conveyed to the taxpayer. They include reduced preparation time, faster refunds, accuracy of returns and acknowledgment of return receipt.

We have certainly come a long way from e-file's humble beginnings. It began as a pilot program in 1986 in three metropolitan areas with 25 thousand returns filed electronically—a miniscule .02 percent of all returns filed. However, e-file's growth literally exploded, and last year, 35.6 percent of returns were e-filed. This year, we expect that over 40 percent of all individual returns will be filed electronically.

Taxpayers can now e-file from their home computers or by using an authorized provider. For those eligible, TeleFile, the IRS file-by-telephone system, is the easiest way to go. To attract potential e-filers, we have added new features and enhancements, such as direct deposit of refunds and payments by credit cards or electronic funds withdrawal. Taxpayers in 37 States and the District of Columbia can e-file their Federal and State tax return in one transmission to the IRS. Taxpayers who need a filing extension can get one automatically by making a simple telephone call. We are systematically removing the last few barriers to e-file to open up eligibility to almost every taxpayer. For example, we recently published final regulations replacing the temporary ones published last year, enabling virtually all 1040 forms and schedules to be filed electronically, without any paper signature document.

Mr. Chairman, I also want to note that the IRS is making progress to better serve the business community's electronic tax administration (ETA) needs. During FY 2002, over \$1.6 trillion came in electronically through the Electronic Federal Tax Payment System, which now includes an online option. In FY 2002, we received more than 3.16 million 941 e-file program returns (Employer's Quarterly Federal Tax Return) and 863,000 returns for 941 TeleFile and On-Line Filing Programs. In FY 2002, over 320,000 businesses used the 940 e-file Program (Employers Annual Federal Unemployment Tax Return), and more than 21,000 partnerships chose 1065 e-file (U.S. Return of Partnership Income) in FY 2002.

We are also working on new initiatives to develop and mature other additional electronic products and services for this important taxpayer segment. For example, later this spring, businesses will be able to apply for an Employer Identification Number online through *irs.gov*. We are also building a new e-file system that will grow and serve taxpayers for years to come. Scheduled to start in 2004, it will address the current system's limitation. For example, it will accept complex business returns, such as 1120s (corporate income tax returns), eliminate software barriers and resolve standardization issues, such as reject code and validations.

Clearly, we have made considerable progress towards RRA 98's ETA goals. In addition, improved electronic exchange of information with taxpayers and practitioners also advances all three of the IRS' strategic goals: service to each taxpayer, service to all taxpayers and productivity through a quality work environment. In its December 2002 report to you on the 2002 Filing Season, the General Accounting Office stated:

"The number of individual tax returns filed electronically grew from about 40.2 million in 2001 to about 46.9 million in 2002, an increase of about 16.5 percent, and the percentage of individual tax returns filed electronically reached 35.9 percent. This 16.5-percent increase over the number of returns received electronically in 2001 was more than the IRS's goal of 15 percent and continued the upward trend in the number of returns filed electronically since 1995. IRS took some positive steps, including an increased focus on

taxpayers and tax practitioners who prepare returns on computer but file on paper, that helped it achieve that increase and that could lead to further increases in the future."

Nevertheless, even with a 16 percent annual growth rate, the IRS would fall short of Congress' extremely challenging 80-percent goal. To meet this ambitious objective, we must make it not only technologically possible, but also attractive to both practitioners and taxpayers to make a permanent change from paper to electronic filing. For example, to build practitioner interest, the IRS will offer later this year a suite of electronic services, such as disclosure authorization, transcript delivery and account resolution, to tax practitioners who file a certain number of returns electronically. The Electronic Tax Administration Advisory Committee (ETAAC) observed in its 2002 report to Congress that these types of *e-services* are a major incentive for practitioners to *e-file* their clients returns. The Administration also undertook several initiatives to build taxpayer interest. For example, in addition to Free File, the President proposed a major incentive in his FY 2004 budget that would extend to April 30 the due date for returns filed and paid electronically.

However, *e-file* cost was a far more complex problem. IRS research and GAO reports identified cost as an impediment to further *e-file* growth. Notwithstanding the many advantages of preparing and filing a tax return electronically, some taxpayers are deterred by cost, or find it prohibitive. For years, the IRS and the tax community would grapple with this issue and had little success resolving it. That changed dramatically with Free File.

Free File's roots can be found in the President's FY 2002 Management Agenda. It contained five Government-wide initiatives, one of which was to expand electronic government. The overarching goal was to "champion citizen-centered electronic government that will result in major improvement in the Federal Government's value to the citizen."

Subsequently, in November 2001, OMB's Quicksilver Task Force established 24 *e-government* initiatives as part of the President's Management Agenda. These initiatives were designed to improve government-to-government, government-to-business, and government-to-citizen electronic capabilities.

One initiative instructed the IRS to provide free online tax return preparation and filing services to taxpayers. In accordance with this OMB directive, the IRS began working in partnership with the tax software industry to develop a solution. Two principles would guide its development: no one should be forced to pay extra to file his or her return and the IRS should not get into the software business.

The IRS believes that private industry, given its established expertise and experience in the field of electronic tax preparation, has a proven track record in providing the best technology and services available. Rather than entering the tax software business, IRS' partnership with private industry will: (1) provide taxpayers with higher quality services by using the existing private sector expertise; (2) maximize consumer choice; (3) promote competition within the marketplace; and (4) meet these objectives at the least cost to taxpayers.

DELIVERING FOR TAXPAYERS

The President stated in the preface to his Management Agenda that "good beginnings are not the measure of success. What matters in the end is completion. . . . Not just making promises, but making good on promises." That is exactly what the Free File partnership did—it made good on its commitment and delivered for taxpayers.

Through the Free File Alliance, LLC (the Alliance), America's taxpayers can now access free, online tax preparation and electronic filing services through our redesigned Web site at www.irs.gov, which received 3.2 billion hits last year, or by going to www.firstgov.gov. These free services will be available this year through April 15, 2003. Some companies will also offer free services through October 15, 2003 to accommodate taxpayers who may need an extension.

The partnership agreement requires that the Alliance as a whole provide free tax preparation and filing to at least 60 percent, or approximately 78 million American taxpayers. The primary candidates for Free File are those taxpayers who prepare their own taxes and still file paper returns. Last filing season, the IRS received nearly 85 million paper returns and nearly 47 million *e-filed* returns.

Each participating software company sets its own eligibility requirements. Generally, these requirements may be one, or any combination of the following: (1) age; (2) Tax Year 2002 Adjusted Gross Income; (3) eligibility to file Form 1040EZ; (4) eligibility to claim the Earned Income Credit; (5) State residency; and (6) active duty military status (if applicable). Unless noted, if the taxpayer is married and filing jointly, only one taxpayer must meet the eligibility requirement.

Initial Free File reports are most encouraging. As of February 5, Alliance members have processed and transmitted almost 639,000 tax returns. This represents approximately 23 percent of the total 2.8 million on-line *e*-filed returns. The Alliance partners will report the number of Free File returns to us on a monthly basis.

Mr. Chairman, I want to stress that Free File differs markedly from the free *e*-filing that some companies offered to select taxpayer groups for several years. It is far better in a number of key areas.

First, it is a multi-year agreement between the IRS and the Free File Alliance that provides free services to millions more taxpayers. Previously, free offers were not consistently available and were subject to modification or discontinuation from year to year.

Second, taxpayers will have easier access. The Free File Web page hosted on *irs.gov* provides in a single location a list of all free offerings.

Third, Alliance members will offer both free preparation and *e*-file service. The taxpayer will incur no cost. Previously, some companies charged for preparation (filling out forms and tax calculations) while offering the transmission free, or provided the preparation free while charging for transmission, or some variation thereof. Under the Free File Agreement, both are free to eligible taxpayers.

Fourth, there will be oversight. The Alliance will be managed by the Council for the Electronic Revenue Communication Advancement (CERCA). The IRS will also monitor the progress of each Alliance member. Should any problems develop, the members are required to alert the IRS. If appropriate, the IRS will remove the company from the online listing until the problem is resolved.

HOW DOES FREE FILE WORK

Before I discuss the actual workings of Free File, I want to reemphasize that the IRS does not formally or tacitly endorse any of the products or services that any of the Alliance companies may offer taxpayers. This is a private matter between the companies and taxpayers. Moreover, using Free File is not contingent on a taxpayer accepting any of these offers. The key word in Free File is “free.”

Upon arrival to the Free File page within *irs.gov*, the taxpayer must determine eligibility for using a particular company’s free service. This can be done two ways. First, the taxpayer may browse the complete listing of Alliance members and their free services. Or, a taxpayer can use a “questionnaire” application (the Free File Wizard) designed to assist the taxpayer to identify those free services for which he or she may qualify.

Each Alliance member will identify its company name and will have a simple description of the criteria for using its free service. Each Alliance member’s company or product name will also be linked to additional information about the company and/or services. Not all taxpayers will be eligible for these free services.

Upon determining eligibility, the taxpayer can link directly to that Alliance member’s free service by clicking their “Start Now” link. Upon doing so, taxpayers will be notified they are leaving the *irs.gov* Web site and are entering the Alliance member’s Web site.

The company’s software will prepare and *e*-file the taxpayer’s returns using proprietary processes and systems. The company will then transmit the electronically-filed return to the IRS using the established *e*-file system, which uses secure telephone lines. Lastly, the company will *e*-mail the taxpayer an acknowledgment file, notifying the taxpayer that the return has been either accepted or rejected.

As part of the Agreement, Alliance members will provide appropriate customer service to their clients. Taxpayers who have service questions or are experiencing problems with the services being offered by a particular Alliance member’s software should contact the customer service function of that particular company. In the event a taxpayer contacts the IRS first, our customer service representatives will have contact information for each Alliance member and if necessary, will refer accordingly.

Mr. Chairman, I want to underscore that Free File’s benefits are identical to those of *e*-file. They bear repeating: (1) reduced tax return preparation time; (2) faster refunds; (3) accuracy of returns; and (4) acknowledgement of return receipt. In other words, the use of free tax preparation software is comparable to the Alliance members’ paid products.

TAXPAYER SECURITY AND PRIVACY

Mr. Chairman, privacy and security are paramount considerations in all of IRS’ electronic services, including Free File. We are absolutely committed to protecting taxpayer privacy and confidentiality. Taxpayer information and data will be protected and the Alliance members must adhere to IRS’ strict privacy standards. To

ensure taxpayer data safety, we required each participating company to obtain both a privacy and security seal certification.

These programs, administered by third party providers, certify that taxpayer return information will be protected from unauthorized access during the tax preparation process. We also encourage taxpayers to visit the company's privacy and security policy located on their commercial Web site.

Indeed, taxpayer security and privacy are woven throughout the Free File process. Tax return preparation is accomplished using proprietary software approved by the IRS. Transmittal is through the established IRS *e-file* system. As I mentioned, each Alliance member must obtain a third party privacy and security certification. Alliance members must also comply with all Federal rules and regulations on taxpayer privacy for paying and free customers. These rules prohibit use of tax return data for purposes not specifically authorized by the taxpayer.

Finally, the information taxpayers provide through the Free File Wizard will be used solely to help taxpayers select a free service; thereafter it will be deleted. The IRS only retains the officially-filed return information.

TAXPAYERS WITHOUT HOME COMPUTERS

Mr. Chairman, as I previously discussed, Free File is premised in part on the principle that no one should have to pay to file a return. That includes taxpayers who do not have access to a computer. Low income should never be a barrier to quality service, including free electronic filing.

Free tax preparation and *e-file* are available in many communities through the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs. Volunteers help prepare basic tax returns for low-income taxpayers, persons with disabilities, the elderly, and non-English speaking people. Taxpayers can call 1-800-829-1040 to find their nearest VITA or TCE site. They may also call AARP—the largest TCE participant—at 1-877-227-7669 to see if there is a Tax Aide site in their community.

However, Free File will not normally be used at VITA sites for a number of reasons. First, we train our thousands of volunteers to use one standard software package, versus the many different ones offered by the Alliance companies. This consistency is both cost efficient and produces a much higher accuracy rate in the volunteers' preparation of taxpayer returns. In fact, we currently enjoy a 98 percent accuracy rate at the VITA sites. Second, we transmit large batches of *e-file* returns at VITA sites; usually 50–100 at a time. Free File is oriented towards the individual taxpayer and was not intended for such high volume use. Third, some VITA sites do not have access to the Internet so Free File is not an option.

Individual taxpayers with incomes of \$35,000 or less can also receive free income tax return preparation and *e-file* help at IRS Tax Assistance Centers (TACs). We extend this courtesy return preparation service to all taxpayers qualifying for the Earned Income Tax Credit, without placing the government in competition with private industry. All of these returns are *e-filed*; we do not deal with paper individual returns. Taxpayers whose income or preparation needs exceed the basic service will receive service options, such as referrals to local volunteer organizations.

To better serve low-income taxpayers, the IRS' Stakeholder Partnership, Education and Communication (SPEC) organization is establishing extensive partnerships with external groups such as local governments, non-profit organizations, private for-profit businesses, and others to create community coalitions. We are focusing our limited resources on providing technical expertise and training while encouraging the community partners to supply resources such as volunteers, space and computer equipment. This business model has rapidly gained national recognition and acceptance.

Our goal is to make our partners as self-sufficient as possible and to identify those organizations that could make available needed resources. This new approach allows the IRS to expand access to low-income taxpayers, provide greater free tax return preparation and filing, and sustain these services over time.

Mr. Chairman, as previously noted, taxpayers are under no obligation to purchase any product from the software company (some participating companies do not offer such services) or to use Refund Anticipation Loans. Obtaining a fee-based product is a decision left to the individual taxpayer. The IRS, as well as many of the Alliance company Web sites, also remind taxpayers that those who *e-file* and use direct deposit often receive their refunds in 10 days or less.

CONCLUSION

Mr. Chairman, in conclusion, Free File is a breakthrough for America's taxpayers. We are putting *e-file* within reach of millions more taxpayers and delivering on the President's commitment to put the needs of citizens first. In addition, we are fol-

lowing up on our commitment to provide taxpayers with top quality service. And we are making the best use of the taxpayers' dollars by processing returns faster and at a lower cost. This new program may be called Free File, but what it gives to millions of taxpayers and our government is invaluable. Thank you.

Chairman HOUGHTON. Thank you very much, Mr. Commissioner. Just a couple of comments here. First of all, we are going to have to push this thing along a little bit because we have three panels. The first is you, Mr. Commissioner, and then I think we have probably a series of votes coming up. Then second, if I understand correctly, there is an IRS Web site that is to be shown; is that right?

Mr. WENZEL. Yes. With your permission, we would like to give you a brief demonstration of our site.

Chairman HOUGHTON. All right.

Mr. LUTES. Okay. Thank you. What I am going to do is just walk you through it. I think there were screen prints made, copies were made available, of what I am going to show. First of all, during—throughout the filing season when you go to www.irs.gov, a site which got over 3½ billion hits last filing season, and we expect that to grow this year, on the front page folks are going to see the link to the Free Filing offering.

By clicking on the Free Filing offering, you go to what we call the Free File splash page. I am not going to go through this page in detail; however, there are a number of links here about the information you need before you start preparing a return, things you should know. There is a one, two, three as to what the steps are of the electronic filing process, to help folks understand, and then there is a series of frequently asked questions around privacy, security, the nature of the contract and the agreement we have with the industry and so forth.

When you are ready to prepare the return you click start, and it will take you to this page, and you have a couple of choices here as to how to use it.

What I am going to take you to first is the “guide me to a service.” There are 17 companies that have agreements with the Free File Alliance to provide services for this filing season. How do taxpayers sort through those companies to determine those that they are eligible for, because each company determines on its own which taxpayers it wants to cover with its offering? By going to “guide me to a service,” there is a series of six questions the taxpayer would answer, and if they answered those questions correctly, and then clicked the submit button, it will then list the offers that they are eligible to use, and then they can click on the company and begin the return. I will show you how that happens in just a moment.

The other way to do this, you can either scroll down the page and see the listing of companies, or if you click “browse all the services,” you lose the top part, and it is easier to browse, and then you look at the companies, and you can read about the companies, who they are covering. You can bring up just a longer description of the companies. When you have selected the company you want to use, either from the wizard or from this list, you click start now, and an important thing I want to illustrate is you get a disclaimer that

makes it clear to the taxpayer that you are no longer going to be in a government site. These are commercial products. The same commercial products that millions of people paid to use last year are being made available for free, but it is through the commercial providers. We want taxpayers to understand. Then they click to leave the IRS site, and then they go to the company site.

Basically, that is the way the process works, and we just wanted to illustrate that we think we have designed this in a way that makes it easy for taxpayers to use and understand how the process will work. Thank you.

Chairman HOUGHTON. Thank you very much, Mr. Lutes. That is great.

Now, let me just ask a quick question, and then I want to pass it along to the others. Why did you choose 2007 to get the 80 percent? What are the factors that are now impeding you from reaching that goal?

Mr. WENZEL. That is a good question because I think that when that was part of the restructuring format of 1998, there was a lot of discussion with the Congress and the IRS. The thinking was that might be a realistic year to achieve that kind of percentage. Back then it was our best thinking that while it was a very, very ambitious goal, and we certainly, at this point in time, see it as a real stretch for us to reach that number. We felt it was the right thing to achieve, and by that year.

Chairman HOUGHTON. Well, it is always good to shoot high, and obviously that is what you did, but, why not 75 percent, or why not 50 percent or something? What led you to believe that in that 10-year period you could do this?

Mr. WENZEL. I think that when we looked at what we experienced—e-file started in the IRS in the filing season calendar year 1986. That first year there was approximately 26,000 returns that were filed. Then we started to see the growth and the acceptance by the public through—from that year forward. We looked at the opportunities that we had with additional incentives that we thought we could put out in terms of encouraging people to convert from the paper filing to electronic filing. The goal, as you know, is also for business returns, so it is all types of tax returns filed with the IRS. Our best feeling was, at the time, that 80 percent, four out of five returns by that year would be filed electronically.

We have—as I mentioned, in terms of what our current track is, in terms of reaching that goal, if it stayed the way it is, with what we expect this year, again we expect a significant growth, we are predicting about 54-million individual returns will be filed electronically as compared to 47 million last year. So, that is another significant growth. We still will not reach the 80 percent, and we continue to work with the industry to find new and, innovative ways to reach our 80-percent goal.

For example, in the President's fiscal year 2004 budget, there is a provision that would extend the filing season from April 15 to April 30 for any individual who would file their tax return with us electronically. We predict, if that should pass, that would provide a significant incentive for people that still file on paper to file electronically. Of note, approximately 132 million form 1040s, individual tax returns, will be filed that calendar year, and when you

look at when those returns are filed, of significance is that a very high percentage, almost half, are coming around April 15. Both refund returns and also, of course, the balance due tax returns are there. We feel that with—the additional 2 weeks from April 15 to April 30, we will reach that group of taxpayers that wait until the end of the due date or near the end of the due date. That will encourage them to maybe file electronically and help us along toward that 80-percent goal.

Chairman HOUGHTON. Thanks very much.

Mr. Pomeroy.

Mr. POMEROY. Thank you, Mr. Chairman.

I want to echo my friend Rob Portman's comments about this being a good thing and commending you for establishing these partnerships that basically facilitate greater access of the American public to e-filing; the greatest benefit, internal math checking to make certain a return is filed correctly, and sparing the time and disruption that an incorrect return would result, as well as quickly accelerating the receipt of the tax return.

What can an e-filer expect by way of time line on a tax return?

Mr. WENZEL. If an e-filer files a tax return with us and also opts to use the direct deposit provision, and they are entitled to a refund, they will probably receive that refund check—I should say not the check, but the refund deposit in their bank account within 10 days.

Mr. POMEROY. I think that is terrific.

Now, I used to be an insurance commissioner, so policing marketplace activity is something that comes naturally to me, and I don't mean in any way to impugn any untoward business practice on your partners, your private sector partners who have done so much to advance this service, but there are some oversight questions appropriately directed at their marketplace activities. Are you aware of whether or not loans are being made, loan services are being made relative to the return by any of your participating partners?

Mr. WENZEL. Yes, there are several that are offering that service. If an individual opts to use that service—it is not required, it is still a free service to file the return.

Mr. POMEROY. Mr. Commissioner, I note that you indicate on page 5 of your testimony that the IRS does not formally or tacitly endorse any of the products or services that any of the Alliance companies may offer taxpayers. I will agree with you on formally, but I don't agree with you on tacitly. As a taxpayer, if I, through the IRS Web site, find myself essentially in a private product of preparing my tax return as a part of a public-private partnership, I do think that there is a tacit acknowledgment by the IRS that the services sold in conjunction with the private partner are acceptable for public consumption.

It is my view that loan activity for the dependency of a return that at maximum is 10 days is highly suspect. If this was an insurance product put before me, I would say, uh-uh. You don't sell this unless there is confusion in the marketplace, because no one would reasonably conclude that they need that loan for that period of time.

Have you scrubbed the products, Mr. Commissioner, to make sure that they pass the smell test for the American consumer?

Mr. WENZEL. Congressman, the refund anticipation loan has been part of this e-file program for some time, and, our view of that is that we emphasize as much as we can as how quick a refund check could come back if you use direct deposit.

Mr. POMEROY. I think you are turning the refund around so quickly that you just really wouldn't need one of those.

Mr. WENZEL. That is the emphasis that we continue to try to make everyone aware of. Our experience has been that the consumer, our taxpayer, still has opted to use the——

Mr. POMEROY. Well, consumers can be confused Mr. Commissioner. Have you ever sat down with your vendors and said, what is the compelling market need for a product of this nature?

Mr. WENZEL. In terms of me personally, in the acting capacity that I have been in, I have not done that.

Mr. POMEROY. I would like the Service to do that due diligence. In my opinion, the marketplace is owed a wide variety of products, and consumers can make their choice. On the other hand, if something on its face really looks as though it probably doesn't serve a valuable purpose to the consumer, we can draw a conclusion that this is sold only by consumer confusion, and we ought not allow products of that nature.

For example, in insurance, I would refuse to approve for the marketplace illusory policies, policies that appeared to provide something, but took it all away with loopholes. This, in my opinion, is kind of an illusory policy. It looks like you are getting a loan, but, heck, you are going to get your refund in 10 days. You probably won't get your loan proceeds until 5, 6, 7 days, so you are spending some money for just a very short, literally maybe a weekend's worth of time, and it just isn't worth it.

What I would like the Service to do—I see I am out of time, and I would just submit for you—I know we want to move this hearing along—several specific items where I would like the Service at the end of this tax year to survey its vendors and get us the information. We would like to find out, for example, the number of people that have purchased these refund anticipation loans from the vendors and such other services as the vendors are marketing.

I just think it is important to keep an eye on this activity. Again, I don't mean to impugn anything on the valuable private partners to this initiative. We just want to, as part of our due diligence, make sure the products are appropriate for the American public. Thank you very much.

Mr. WENZEL. Congressman, we look forward to providing you with the information that you requested.

[The information follows:]

Internal Revenue Service
Washington, DC 20224

Answer: First, we should make it clear that companies involved in the Free File alliance are not our "vendors." Rather, we have an agreement with them that is not contractual in nature. This is a partnership agreement intended to provide the opportunity for free filing of Federal income tax returns over the Internet to as many people as possible. The nature of the agreement was to take the same product that millions of people have paid for and to make those products available for free.

Taxpayers who use tax preparation software generally want to receive their refunds as quickly as possible. We have made strides over the past several years to accelerate the delivery of tax refunds through the electronic filing system. However,

some taxpayers have traditionally sought refund anticipation loans as a way to get their refunds even faster. The practice of using tax refunds as loan collateral goes back many years, predating the advent of electronic filing. We anticipate that with the rollout of the Customer Account Data Engine over the next several years taxpayers will be able to receive refunds in a week or less, thus, reducing the demand for refund anticipation loans.

Chairman HOUGHTON. Okay. Thank you very much, Mr. Pomeroy.

Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman. Commissioner Wenzel, you were rather generous in your response to our earlier question about how the IRS came up with this 80 percent, because we came up with it for you. He was pretty nice to you actually, Amo, on that one. We came up with it not so much in the legislation, but it came out of the Commission's work, again, 2 years of studying this and trying to set an ambitious but, we thought, realistic goal.

We are disappointed we are not further along, because we think electronic filing is both good for the tax system and also very good for the taxpayer. We also did not put in place any penalties for the IRS not achieving that goal. We established it as a goal, not a mandate, and we thought it was appropriate to encourage it.

One of the sticking points had been this notion of getting folks who have relatively simple returns particularly into the electronic system in a free way, and the cost, which I think only averaged last year about \$12 or \$13, but that cost alone kept people from filing electronically. Instead they went through the paper route with all the error associated with that on their part and the IRS part, and all the additional costs, all the additional costs to you to have additional people to open those forms and work through the system, and all the downstream costs we talked about earlier to the taxpayer where the taxpayer ends up getting, because of a mathematical error or some other error, a phone call from the IRS or a letter from the IRS. It begins sometimes a string of back-and-forth that sometimes our congressional offices get involved with, which is enormously frustrating to taxpayers and to the system, and costly.

So, it is a good thing, and the question is how are we going to do that? I know the private sector was very concerned, as was I, frankly, about the IRS competing with the private sector, that you are not really in the software business, and you are not likely to be as successful, frankly, or as innovative as the private sector in coming up with new ways to encourage people to file electronically.

So, again, I commend you for working out an arrangement with the private sector where they are going to offer this as a free service at least to folks who are up to the 60th percentile on income. I think it will be a major push if we advertise it properly, and that is what I love about your Web site, which has been very successful, and I think both the private sector and you ought to redouble our efforts in term of letting people know how this is simpler, easier and better for them.

A couple of questions, if I might. First on the error rate. What is the error rate now on paper returns?

Mr. WENZEL. The error rate on the paper returns continues to run as high as 22 percent as you previously mentioned, and it really hasn't changed that much in years. It still could vary.

Mr. PORTMAN. Roughly of that 22-percent error, which is an enormously high number, roughly half of that is attributable to the taxpayer; is that correct?

Mr. WENZEL. What has generally been the trend is taxpayer error return, third-party preparation error, or the IRS making the mistakes.

Mr. PORTMAN. A lot of it is transposing the numbers by your folks.

Mr. WENZEL. Transposition of the numbers.

Mr. PORTMAN. Hit return. You are then putting it into the computer rather than having it come straight through on an electronic form.

Mr. WENZEL. That is correct, Congressman. It is the key entry that has a tendency to make a mistake.

Mr. PORTMAN. How about the error rate on the electronic filing?

Mr. WENZEL. The electronic error rate, again, the numbers that you mention are right on in terms of somewhere—1 percent or less. It is a very, very low rate.

Mr. PORTMAN. It is an incredible savings and difference.

On the refund anticipation loans, that is one issue out there the private sector is now going to have an opportunity to have people go through your site through and then to a free service to file, and the notion that my colleague from North Dakota mentioned, which I agree with, is you don't want to have people who are going to get a quick refund on average 10 to 14 days be pressured into getting into these refund anticipation loans, which is not necessarily good for the taxpayer. On the other hand, I am not sure it is as big a problem as we are making it out to be, because I don't think many people do that.

Do you have any data on how many folks who file electronically actually seek a refund anticipation loan?

Mr. WENZEL. I don't have that in front of me. Do you?

Mr. LUTES. Yes. I can address it in general terms. What we capture is information about financial products related to the return. There is an financial product indicator that comes to us electronically. However, financial products include a variety of services, not only refund anticipation loans. For refund anticipation loans, we do know is that the majority of those are by taxpayers who go to a tax professional. The refund anticipation loans on online products, which these are offering online Web products, according to the industry is less than 1 percent.

The other thing I would say in response to the question is, if you go to the sites and you look to the 17 sites, they vary. They are commercial sites; they vary. Some will have a line item on the front page that talks about the fact that you can get a quick loan. However, many of the sites, if you look at their front page, three levels down, emphasize you are electronically filing; you are going to get your refund much faster as a result of the electronic filing. They really emphasize that. For those taxpayers who then do want it faster, they offer the service. I think there is going to continue to

be some demand until we are able to deliver our modernization so we can deliver refunds even faster than the 10 days.

Mr. PORTMAN. So, you think that 1 percent figure is accurate, that only 1 percent of taxpayers who file electronically actually seek a refund anticipation loan?

Mr. LUTES. It is 1 percent who file electronically using the on-line, using Web or the shrink wrap products. Those who file electronically using a practitioner, the number is higher.

Mr. PORTMAN. My time is up, but certainly more information as to the speed at which someone can get a refund is going to affect that, and I assume that that is something that you can communicate. Again, I commend you for this program, and I yield back my time, Mr. Chairman.

Chairman HOUGHTON. Thanks.

Mr. Kleczka.

Mr. KLECZKA. Thank you, Mr. Chairman. Mr. Lutes, one quick follow-up question to the whole issue of tax refund loans. What is the average charge for these loans? Let's say I did a paper return. Do you know what that firm might be charging, because the refund might be a heck of a lot longer than the electronic?

Mr. LUTES. It varies very widely if you are using a tax professional, depending upon the complexity of the return if you are looking at the entire charge. Usually the refund anticipation loans typically—and I don't know that this is 100 percent the rule—but typically there is a flat fee that is charged, and I have seen some in the range of \$60, \$50, but usually I think it would be safe to say that \$50 to \$70 range would be the charge.

Mr. KLECZKA. Have you seen any higher or done on a percentage?

Mr. LUTES. I really can't answer that question because I haven't gone through and looked at all the pricing, because one of the things to remember is the idea of using a tax refund as collateral for a loan predates electronic filing. It has been around for years. What we actually see, we can see on the on-line sites, if we go and look site by site at what is there. In the practitioner office we don't have any real system for collecting that data. What we do, though, is emphasize in our guidelines for electronic filing originators they have to apply be approved, and we can suspend them.

One of the things that we monitor is people who are implying that what folks are getting is a faster refund. We make it clear that they have to communicate clearly to the taxpayer it is a loan, and there is a fee. This is not IRS doing this. This is a bank.

Mr. KLECZKA. I think it would be wise for the Service to look at not only the fee being charged for the electronic file, but all firms charging a fee, just to make sure that our taxpayers aren't being gouged. Thanks.

Chairman HOUGHTON. Okay. Mr. Johnson is not here. Ms. Tubbs Jones.

Ms. TUBBS JONES. When you are new, you can't even find the microphone, but I am going to get it together here.

I think also it might be interesting to kind of take a look at the agreements with the companies to—or I would like to have a copy of the agreement. I am not saying in terms of review. I don't want to tarry on that part of the conversation. I am sure that a number

of my colleagues have asked enough questions. I guess what I would be interested in knowing is you said that there will be—there are locations where taxpayers can get volunteers to help them with these services. How is that set up?

Mr. WENZEL. We have had a voluntary income tax preparation activity for many years, I would say, approximately 30 years, throughout the country. The AARP is one of the principal organizations that assist us, retired accountants or just volunteers that belong to that organization come in and we train them. There are college students, a whole range of individuals that this time of year realize how important it is to meet one's financial responsibility to our country and want to offer assistance. Those sites are staffed by these volunteers evening hours, during the day, during the week, but especially on Saturdays.

Ms. TUBBS JONES. How do—say, for example, if I wanted to know who was doing volunteer IRS, filing or assistance with filing in my congressional district, who could give me that information?

Mr. WENZEL. We try to publicize that through our own www.irs.gov Web site in terms of where the locations are. We solicit the support of the volunteer organizations to reach out and also publicize that. The media is very cooperative in publicizing locations, times and dates.

Ms. TUBBS JONES. What else did I have? I probably had some more questions, but since we are near the end of the time, I am just going to pass on that so that they can be gone since everybody else is gone. Okay.

Mr. PORTMAN. [Presiding.] I thank my colleague from Cleveland, and, Mr. Wenzel, we appreciate your testimony. Thank you, Mr. Lutes. Appreciate your testimony, and the program will now go to the next panel.

Kevin Belden will come forward; Michael Cavanagh. Gentlemen, thank you very much. Chairman Houghton has gone to vote so he can come back and be with us toward the end of this panel. We do have another panel: Ms. Olson, who is going to be joining us for the third panel. We have a vote now, which will be separated by about a 20-minute period until the next vote, which is a motion to recommit, so we thought it would be best to try to keep this moving.

Mr. Belden, thank you very much for being here. Mr. Kevin Belden is Chairman of the Electronic Tax Administration Advisory Committee (ETAAC). Then Mr. Michael Cavanagh. Thank you for being here. Mr. Cavanagh is the manager of the Free File Alliance.

I would like to remind the witnesses that we have a 5-minute rule on testimony; however, we might be a little generous with that since Members have all gone to vote. If you could please direct your testimony to me, and, again, Mr. Houghton should be returning shortly. Mr. Belden.

STATEMENT OF KEVIN BELDEN, CHAIRMAN, ELECTRONIC TAX ADMINISTRATION ADVISORY COMMITTEE, AVERILL PARK, NEW YORK

Mr. BELDEN. Mr. Chairman, Members of the Subcommittee and distinguished guests, my name is Kevin Belden. I am honored to serve again this year as Chairman of the IRS's Electronic Tax Ad-

ministration Advisory Committee. Other panelists are presenting detailed information this afternoon about the genesis, the characteristics and benefits of the Free File initiative. My remarks will focus more on addressing Free File in the larger context of congressional goals for electronic filing.

We are approaching the midpoint between 1998, when those goals were established, and 2007, when the target was to be achieved. The goals have been powerful motivators for focusing IRS resources on electronic filing initiatives. While the IRS has made considerable progress at the current rate of adoption, electronic filing rates will fall short of the target.

Initial IRS efforts focused on expanding the availability of electronic filing particularly for individuals. Those were necessary first steps, but we have since learned that offering electronic filing options does not by itself lead to their use. The vast majority of individual tax filers are able to file electronically, yet just under 36 percent of all individual returns were electronically filed this past year.

The key challenge to increasing electronic filing is to stimulate demand by taxpayers and by tax preparers. To do so the IRS will need to overcome increasingly challenging barriers to adoption. Those barriers include cost of electronic filing, the continued preference for paper filing, lack of awareness of electronic filing alternatives, and concern about privacy and security. Some of these barriers can be addressed through education and marketing, but the bottom line is that the benefits offered today by electronic filing are not sufficiently compelling for all taxpayer and practitioner segments. More needs to be done to increase the value of electronic filing for these segments.

There are approximately 52-million individual tax returns filed each year by taxpayers who prepare and file their own tax returns. The new Free File Alliance initiative primarily targets this group of taxpayers. This innovative approach allows each of the players in the tax administration value chain to focus on what they do best. The IRS will receive more electronic returns while avoiding the cost of developing its own online filing product. The IRS can then focus its efforts on modernizing its back-end systems and electronic filing platforms to provide greater value and increased electronic services, each of which will increase and stimulate the demand for service. The initiative preserves and strengthens government and industry cooperative relations, which have led in large part to the electronic filing gains achieved to date.

However, the Free File Alliance initiative alone will not solve the problem of attaining the 80-percent electronic filing target by 2007, in the opinion of the ETAAC. Cost is only one of the inhibitors to electronic filing, and access to a computer and the Internet is an impediment for many of the target population. In addition, many in that segment are comfortable with manual preparation and may be resistant to change.

Product offerings in future years will need to incorporate free State filing. Since a number of States are offering free online income tax filing of State tax returns, the Free File Alliance members view them as competitors and are not inclined to cooperate in

offering free combined filing of Federal and State returns in those States.

Addressing this challenge will lead to greater use of Free File Alliance products in the future. Many of the essential elements for rapidly expanding electronic filing participation are falling into place.

Mr. PORTMAN. Mr. Belden.

Mr. BELDEN. Yes.

Mr. PORTMAN. I am sorry to interrupt you. We had hoped that Mr. Houghton would be back. He is not as fast a sprinter as we thought. I am going to sprint over and vote, and we will be back. If you could stop there at your testimony, and then we can pick up when you come back. We will be recessing just for a short period of time until Mr. Houghton comes back.

Mr. BELDEN. Be glad to. Thank you.

[Recess.]

Chairman HOUGHTON. [Presiding.] Okay. Let's continue the hearing. Mr. Belden, good to see you, and I am sorry we weren't here earlier. Anyway, we are delighted to have you here, and maybe you want to continue your statement.

Mr. BELDEN. Yes, Mr. Chairman. I was just making the point that while ETAAC is extremely supportive of the Free File Alliance, that it in and of itself is not going to completely solve the 80 percent—the problem of achieving the 80-percent goal. Cost is only one of the inhibitors to electronic filing, and access to a computer and the Internet is an impediment for many in the target population segment. In addition, many in that segment are comfortable with manual preparation and may be resistant to change.

Product offerings in future years will need to incorporate free State online filing since a number of States are offering free online income tax filing of State tax returns. The Free File Alliance members view them as competitors and are not inclined to cooperate in offering free combined filing of Federal and State returns in those States.

Addressing this challenge will lead to greater future use of Free File Alliance products. Many of the essential elements for rapidly expanding electronic filing participation are falling into place. The IRS is modernizing its core tax administration systems to make them more capable, flexible and responsive. New electronic service delivery channels are being implemented, including secure Web portals for access to electronic services, and taxpayer account information by IRS employees and trusted third parties.

E-services are highly anticipated and will be much appreciated by the professional tax community. The IRS is also implementing the first of a series of modernized electronic filing platforms. These modern new electronic filing platforms are based on industry-accepted standards for data-sharing and communication, making them cost-effective for the IRS and attractive for the software developers and the tax practitioners.

The growth of the Internet and the development of new business models have prompted a change in the way we think about tax administration. The new view, which you might think of as end-to-end electronic tax administration, acknowledges that third parties in the tax business are the IRS's partners in serving a common

customer, the taxpayer. In this vision taxpayers would have multiple choices in terms of how they interact with the IRS and what value-added services they choose to use. They would not be e-filers, but e-customers.

Tax practitioners would choose from a variety of third-party software products offering highly interactive e-services made possible through online communication with IRS systems. A full range of these services would be available, allowing each practitioner to make a clean break from their paper process.

Employers and financial institutions would file withholding information returns electronically, providing electronic copies to taxpayers and their designated representatives. Financial institutions may integrate tax account information with other customer financial information into an electronic financial portfolio, allowing online account inquiry, customized financial advice, tax filing and payment reminders, and electronic tax payments.

The IRS would act as an integrator of this network of tax administration service providers. Its own electronic tax administration processes and systems would be designed to facilitate the smooth interaction of its internal functions with the specialized functions of its third-party partners and taxpayers while protecting the security and confidentiality of taxpayer information.

As has happened with the Free File Alliance, in this environment the existing tax administration service providers would likely create new and innovative offerings, and new providers would undoubtedly enter the market with fresh ideas and new business models. Taxpayers will be the ultimate beneficiaries.

Thank you, Mr. Chairman, for the opportunity to provide ETAAC's views on electronic filing.

[The prepared statement of Mr. Belden follows:]

**Statement of Kevin Belden, Chairman, Electronic Tax Administration
Advisory Committee, Averill Park, New York**

Mr. Chairman, Members of the Subcommittee and distinguished guests, my name is Kevin Belden and I'm honored to serve again this year as Chairman of the Internal Revenue Service's Electronic Tax Administration Advisory Committee (ETAAC). Thank you, on behalf of the Committee, for the opportunity to share our views on the progress and future direction of electronic filing. ETAAC was established to provide continued input to the development and implementation of the IRS strategy for electronic tax administration. Members of ETAAC represent a diverse cross-section of IRS partners, customers and stakeholders, whose interests and insights are critical to the overall attainment of electronic filing goals.

The Progress of Electronic Filing

We're approaching the midpoint between enactment of the Restructuring and Reform Act of 1998—which set goals for electronic tax administration—and the year 2007 when those goals were targeted to be achieved. The goals Congress has set for electronic filing have been powerful motivators for focusing IRS resources on electronic filing initiatives. However, while the IRS has made considerable progress, at the current rate of adoption electronic filing rates will fall short of the goals. Initial IRS efforts focused on expanding the availability of electronic filing, particularly for individuals. While those were necessary first steps, we've since learned that offering electronic filing options doesn't, by itself, lead to their use. The vast majority of individual tax filers are able to file electronically, but just fewer than 35% (46.3 million) of all individual returns were electronically filed this past year.

Business electronic filing initiatives to date have been limited, but well received. Business returns are generally more complex than individual returns, as are the filing, authentication and signature processes. Work is underway, as part of a comprehensive strategy, to develop and market additional opportunities for business e-filing that add value for businesses while improving IRS internal operations.

Taxpayers and government tax agencies are not the only players in the tax administration life cycle. Third party tax practitioners and tax software developers are key links in the value chain. Tax practitioners file 60% of all individual returns and at least 85% of all business returns using tax software acquired from commercial developers. Many of the returns prepared and filed by taxpayers themselves are prepared using private sector tax software. The key challenge to increasing electronic filing is to stimulate demand by taxpayers and tax preparers. That, in turn, is dependent on increasing the value of electronic filing for taxpayers and the IRS' third party partners in tax administration.

To improve the growth rate of electronic filing, the IRS will need to overcome increasingly challenging barriers to adoption. Research indicates that those barriers include a continued preference by taxpayers for paper filing, lack of awareness of e-filing and how to do it and concern about privacy, security and the role of third parties in the process. Some of these barriers can be addressed through education about the advantages of electronic filing—faster refunds, electronic receipts that offer proof of filing, convenience, accuracy and reduced likelihood of receiving a notice from the IRS. But the benefits offered today by electronic filing are not compelling for all taxpayer and practitioner segments. More needs to be done to increase the value of electronic filing for these segments. It needs to become part of a routine way of doing business.

Free File Alliance—An Innovative Approach to No-Cost Online Filing

There are approximately 52 million individual tax returns filed each year by taxpayers who prepare and file their own tax returns. At least 30 million of these returns are prepared on a computer, but then printed and mailed to the IRS. The new Free File Alliance initiative primarily targets this group of taxpayers. The Free File Alliance eliminates cost as an obstacle for a potential target segment of at least 60% of individual taxpayers. This innovative approach allows each of the players in the tax administration value chain to focus on what they do best. The IRS will receive more electronic returns, while avoiding the cost of developing its own online filing product. The IRS can then focus its efforts on modernizing its backend systems and electronic filing platforms to provide greater value and increased electronic services. The initiative preserves and strengthens government/industry cooperative relations which have led, in large part, to the electronic filing gains achieved to date. Taxpayers have a choice of service providers, each offering unique value in a virtual marketplace.

However, the Free File Alliance initiative alone will not solve the problem of attaining the 80% electronic filing target by 2007. Cost is only one of the inhibitors to electronic filing. Demonstrating the value of electronic filing will continue to be a challenge. Many in the target segment are comfortable with manual preparation and may be resistant to change. Free File Alliance products will need to prove their value by saving time, adding convenience, improving accuracy and contributing to expedited refunds. To do so, the product offerings in future years will need to incorporate free State online filing.

Lack of access to a computer and the Internet will likely be a roadblock for many in this group. The IRS will need to identify and encourage public access to computers and the Internet in such places as IRS and other government offices, community colleges, public schools, libraries and post offices. Additionally, tax preparation companies may realize significant client development benefits from providing free Internet access in their offices.

A Foundation for Future Growth

Many of the essential elements for rapidly expanding electronic filing participation are falling into place. The IRS is modernizing its core tax administration systems to make them more capable, flexible and responsive. New electronic service delivery channels are being implemented, including secure Web "portals" for access to internal information resources, services and taxpayer account information by IRS employees and trusted external customers, including taxpayers' authorized representatives.

The IRS is beginning to offer electronic services, like the ability to register as a trusted external customer and for a new business to obtain an Employer Identification Number (EIN) online. These e-services are highly anticipated and will be much appreciated by the professional tax community. The IRS is also implementing the first of a series of modernized electronic filing platforms, beginning with the Employment Tax e-Filing System earlier this month, to be followed by Corporation Income Tax (1120 and related forms) e-Filing in January 2004. These modern new electronic filing platforms will be based on industry-accepted standards for data

sharing and communication, making them cost-effective for the IRS and attractive to software developers and tax practitioners.

ETAAC encourages the IRS to continue the current efforts and to expand them rapidly to include a broader range of e-services and to encompass modernization of the 1040 e-filing platform, as well as other business tax return types. While these new e-services and modernized e-filing platforms require an upfront investment of resources, ETAAC firmly believes that the costs will be more than offset by the benefits, including significantly increased electronic filing by those practitioners who still file computer-prepared individual income tax returns on paper (30 million such "V-code" returns were filed by practitioners last year) and a substantial increase in the percentage of e-filed business tax returns.

A Future Vision of "End to End" Electronic Tax Administration

As has happened in the private sector, the growth of the Internet and the development of new "networked" supply chain business models have prompted a change in the way we think about tax administration. The new view—which you might think of as "end to end electronic tax administration"—acknowledges that third parties in the tax business are also the IRS' partners in serving a common customer—the taxpayer.

In the private sector, new end to end business models—driven by innovative thinking and enabled by new technologies—are emerging in industries with characteristics similar to the tax administration environment. Those characteristics include a diverse customer base, complex and highly-specialized functions, seasonal peaks and valleys and a high level of dependency on value-adding intermediaries. Highly-competitive businesses have responded to new market challenges and opportunities by shifting their view from streamlining internal processes and systems to integrating internal and external service providers in a seamless, end to end service delivery value network. That view takes into account business partner capabilities and needs, creating a flexible, dynamic environment that allows each partner to perfect its own specialized processes, reduce costs, enhance value and respond quickly to customer needs.

For the IRS to achieve the electronic tax administration goals of RRA 98, it needs to promote an end to end vision of tax administration with these characteristics:

Taxpayers would have multiple choices in terms of how they interact with the IRS (e.g., directly or through an authorized representative; electronically, by phone or by mail) and what value-added services they choose to use (e.g., online preparation and filing services from a variety of competing vendors). In this vision, taxpayers would not only be e-filers, but e-customers. They could decide among a variety of options how they would like to view their own IRS account information, perhaps choosing traditional paper correspondence, maybe through a secure session at irs.gov, or potentially as part of an electronic financial portfolio offered securely by a private sector financial institution. Taxpayers would be able to retain their books and records electronically, a particular benefit to large corporations.

Tax Software Developers would continue to be active participants with the IRS in defining new services that would be beneficial to mutual customers. The IRS would define changes requiring software investments in ways that minimize costs and maximize value for the tax software companies. The IRS would also provide electronic services and secure account access in ways that would integrate securely with private sector software. For example, the tax software used by a practitioner would automatically validate taxpayer identification information in near real time and securely pre-populate account information, such as Estimated Tax payments, reducing costs for the practitioner and increasing accuracy for the taxpayer and the IRS. Tax software companies, in turn, would be prompted by competitive market pressures to enhance other features of their software, such as providing direct links into IRS tax research knowledge bases.

Online Filing Providers similarly would have access to electronic services that they could incorporate into their tax preparation and e-filing offerings. Their services would be easily accessed and understood by taxpayers. The new Free File Alliance is an excellent example of how this type of business model could benefit the IRS, its partners and its customers.

Tax Practitioners, in the end to end vision of tax administration, would choose from a variety of third party software products offering highly interactive e-services, made possible through online communication with the IRS' systems. A full range of e-services would be available, allowing practitioners to make a clean break from their paper processes. Those services would include the ability to e-file all form types, research taxpayer account information online or through a direct software interface, correspond electronically with the IRS, easily obtain electronic taxpayer signatures and maintain all records electronically. Information returns would be

filed electronically by employers and financial institutions (2D bar coding of information returns would be a helpful interim enhancement), and made available timely to taxpayers, practitioners and tax agencies.

Other Government Agencies, such as SSA, FMS and State tax agencies, would exchange information electronically with the IRS to improve compliance, taxpayer service and processing accuracy. Federal and State filing obligations would be addressed in a single transaction.

Employers and Financial Institutions would file withholding and information returns electronically, providing electronic copies to taxpayers and their designated representatives. Financial institutions may integrate tax account information with other customer financial information into an electronic financial portfolio, allowing online account inquiry, customized financial advice, tax filing and payment reminders and electronic tax payments. As an incentive to customers, financial institutions and other third parties may offer free online tax preparation and filing, provided by a specialized online filing provider.

Achieving the Future Vision

The IRS would act as an integrator of this network of tax administration service providers. Its own electronic tax administration processes and systems would be designed to facilitate the smooth interaction of its internal functions with the specialized functions of its third party partners and taxpayers. The focus of its electronic tax administration initiatives would be to increase value and reduce costs for all the participants in the tax administration service network, while protecting the security and confidentiality of taxpayer information.

Those initiatives would enhance timely processing of returns and refunds and speedy resolution of issues, standardize interface and data transfer protocols, provide simple and comprehensive views of taxpayer account information and facilitate the ability of third parties to dynamically tailor services to the needs of individual customers. Key enablers of this future vision, led by the IRS, would be the creation of "natural integration points," such as an electronic means for designating, tracking, updating and authenticating authorized representatives, definition of open standards such as XML for data exchange and development of simple but effective data encryption and electronic signature mechanisms.

In this environment, existing tax administration service providers would likely innovate with new and creative electronic service offerings and new providers would undoubtedly enter the market with fresh ideas and new business models. Taxpayers will be the ultimate beneficiaries.

That concludes my remarks to the Oversight Subcommittee. Thank you for the opportunity to comment on the future direction of electronic filing.

Chairman HOUGHTON. Thank you very much, Mr. Belden. Now Mr. Cavanagh, who is the manager of the Free File Alliance in Alexandria. Please submit your testimony.

STATEMENT OF MICHAEL F. CAVANAGH, MANAGER, FREE FILE ALLIANCE, ALEXANDRIA, VIRGINIA

Mr. CAVANAGH. Good afternoon, Mr. Chairman, Mr. Pomeroy. My name is Michael Cavanagh, and I serve as the industry manager of Free File Alliance.

Chairman HOUGHTON. Could you put the microphone a little closer to you?

Mr. CAVANAGH. Is that better?

Chairman HOUGHTON. Yes. Much better.

Mr. CAVANAGH. Okay. Pardon me. I am accompanied by Stephen Ryan, General Counsel to the Alliance, and a partner in the Manatt law firm.

The Free File Alliance was launched last month on January 16, at a press conference conducted by the Acting Treasury Secretary, the Office of Management and Budget Director, and Acting IRS Commissioner Wenzel. Currently, 17 industry companies offer free services to taxpayers.

We can now report, as you heard from the IRS, that as of last week almost 650,000 free returns already had been processed, transmitted and accepted by the IRS. Further, we know that 20 percent of the total traffic of visitors to the IRS site is going to the Free File page, and that the total number of hits at the site is very significant. The total number of individuals who will return to file their taxes through the program before April 15 remains to be seen, but we fully anticipate that the figure will represent a very large addition to the 650,000 returns that have already been filed.

We believe that this is a truly unique public-private partnership that offers American taxpayers significant benefits. It is a far better public policy approach than the idea that has been suggested in some quarters that the government should spend tens of millions of dollars to enter the tax preparation marketplace, thus stifling competition and dampening the innovation that has been so notable in the products and services emanating from this industry over the past several decades. Despite some calls for government intervention in the marketplace, we have not heard anyone suggest that government software could possibly display the quality, diversity and continuous innovation so readily visible in the competitive marketplace.

Mr. Chairman, this initiative obviously provides tens of millions of Americans with the option of preparing and filing their taxes electronically online for free. Clearly we cannot say yet how many taxpayers will take advantage of this offer.

We look forward to answering your specific questions about the Alliance and its operations.

[The prepared statement of Mr. Cavanagh follows:]

**Statement of Michael F. Cavanagh, Manager, Free File Alliance,
Alexandria, Virginia**

Good afternoon, Mr. Chairman, and distinguished Members of the Subcommittee. My name is Michael F. Cavanagh and I serve as the industry Manager of the Free File Alliance LLC. I am accompanied by Stephen Ryan, General Counsel to the Alliance and a partner in the Manatt law firm.

The Free File Alliance was launched last month, on January 16, at a press conference conducted by the Acting Treasury Secretary, the OMB Director and the Acting IRS Commissioner. Currently, seventeen industry companies offer free services to taxpayers, each serving at least 10% of American taxpayers, and many considerably more.

We can now report to you that the initial response to the Free File initiative has been very, very strong. As of last week, almost 650,000 free returns already had been processed, transmitted, and accepted by the IRS. Further, we know that 20% of the total traffic of visitors to the IRS site is going to the Free File page, and that the total number of hits at the site is very significant. The total number of individuals who will return to file their taxes through the program before April 15 remains to be seen, but we fully expect that the figure will represent a very large addition to the number of returns already filed.

We believe that this is a truly unique public-private partnership that offers American taxpayers significant benefits. It is a far better public policy approach than the idea suggested in some quarters that the government should spend tens of millions of dollars to enter the tax preparation marketplace, thus stifling competition and dampening the innovation that has been so notable in the products and services emanating from this industry over the past several decades. Despite some calls for government intervention in the marketplace, we have not heard anyone suggest that government software could possibly display the quality, diversity or continuous-innovation so readily visible in the competitive marketplace.

Mr. Chairman, this initiative obviously provides tens of millions of Americans with the option of preparing and filing their taxes electronically online for free. Clearly, we now can say that many taxpayers are taking advantage of this offer.

Bringing the program to fruition has taken an intense amount of work over the past year. First, I would like to acknowledge support that we have received from a number of Members of Congress.

We would also like to thank the Bush Administration, and within the Administration, the Department of Treasury, the Internal Revenue Service, and even the Department of Justice (which provided clearance and review). On a personal level, we would like to thank former IRS Commissioner Charles Rossotti and IRS Director of Electronic Tax Administration Terry Lutes. Since November, Acting IRS Commissioner Bob Wenzel has taken up the leadership of the program. At the Treasury Department, Christopher Smith, Counselor to the Secretary, and George Wolfe, Deputy General Counsel, played a critical role in achieving the Agreement.

For industry, there is an important philanthropic basis to the services donated under this program, but there is also a practical side to the Agreement. It permits stability in the marketplace of providing tax preparation services and, again, fundamentally the continuation of a successful competitive marketplace without government competition.

The Alliance companies are offering readily available commercial products, the same as are being offered with paid preparation. The members of the Free File Alliance look forward to working with this Subcommittee and others in the Congress to ensure that this program serves the American taxpayer to the maximum extent possible.

We look forward to answering your specific questions about the Alliance and its operations.

Chairman HOUGHTON. Thank you very much. I am just going to ask one question, and then I will turn it over to you. I guess one of the things that comes to mind is what is going to happen if the Alliance members fail to meet their side of the bargain to allow 60 percent of the taxpayers to file online electronically?

Mr. CAVANAGH. Mr. Chairman, one of the questions as this entire project was being discussed over the course of the last year was would, in fact, there be participants among the private sector who would partner with the government, and would they, in fact represent 60 percent of total tax-paying public, would those offers total that. There was some question.

We had the question answered as we moved into this filing season. There is well over 60 percent that has been provided with free service should they choose to use the Free File option. The agreement calls for, if there were ever to be a dip below 60 percent, that the government would go to the private sector and say that the private sector is not living up to its side of the bargain in maintaining the 60 percent. At that time, the industry would make an effort to within a period of some months, within 6 months, regain the 60-percent threshold.

Again, that has not turned out to be an issue as we see things operating today, but there would be that process that has been outlined in the operating agreement.

Chairman HOUGHTON. Okay. Thanks. How about you, Mr. Belden? Do you have any comments?

Mr. BELDEN. No, nothing to add to what Mr. Cavanagh had to say on that point, sir.

Chairman HOUGHTON. Good. Fine. Mr. Pomeroy.

Mr. POMEROY. Thank you, Mr. Chairman.

As I understand it, the IRS has—first of all, let me commend you, Mr. Cavanagh, and the members of your association. It is exciting for us to see this kind of public-private partnership, and the response looks pretty promising so far this tax season.

As I understand it, there are not particular standards relative to participating companies? What is the core deal that has to be offered?

Mr. CAVANAGH. Oh, yes, there are specific standards. Each of the participants has to agree to the details in the operating agreement, and some of those were outlined by the Commissioner. They must obtain security and privacy seals. They must, of course, go through a testing with the IRS, and they must agree to live by a variety of elements of the operating agreement. We have supplied to the Chairman the operating agreement. So, there is a whole framework of requirements that each of these companies has agreed to comply with in order to participate in this Alliance.

Mr. POMEROY. What about the—obviously, with the brave new world of the Internet, there has been a lot of business models that have rolled out that have not been so successful. We are looking, and there is a hope here that there will be a business opportunity for, on the one hand, free filing; on the other hand, there is a business relationship that can be established which will make it pay for the private partner participants.

Is there any review by the IRS of what services are offered that represent the business plan for how this works with the company?

Mr. CAVANAGH. Well, the principle has been that during this long discussion we began with former IRS Commissioner Rossotti back January a year ago, and the concept evolved into what this would be. One of the real concerns was that industry players might suggest that they would offer dumbed-down versions to the American public of software and whatever. The commitment was that there must be commercial services that are offered to the public would be the ones that would be part of the Free File Alliance.

Now, within that—within those commercial products, there in many instances are various add-ons. You were talking about one before. There are a whole range of different things that the public can get, and there never was any sense that in the Alliance process that there should be any element of service being taken away. The core tax product must be free, and there must be absolutely no quid pro quo.

Mr. POMEROY. What worries me is basically we are—a basic fee for filing might be easier and more of a straight-up method to have this paid for than unbundled services that are—that involve a variety of costs and maybe—purchased by people that aren't quite sure whether they need them or not. That is the source of my concern.

Again, I have heard no complaints of untoward market activity. I am just trying to look at this going forward. So, I certainly, again, salute your Members. I don't mean to impugn anything inappropriate on their behalf.

Do you think there should be some dialog with the IRS or some review by the—in terms of where these products fall? Obviously as an association you can't really do it. It would seem to be antitrust activity if you did. Is there an area where this Committee ought to have some concern?

Mr. CAVANAGH. Well, Congressman, you were referring to one particular set of products, which the Commissioner and the ETA Director made the point that indeed that product is primarily offered and primarily used by millions of Americans not in the online

arena, but in other arenas. Certainly any product like that is, of course, appropriate for your oversight. It doesn't have anything to do with the Free File Alliance.

Mr. POMEROY. What are people buying, the 600,000 that have filed this year; do you know?

Mr. CAVANAGH. Pardon me?

Mr. POMEROY. I see that my time is expired. I will just close with what—have you surveyed your members, and what are taxpayers purchasing by way of add-on services of the 600,000?

Mr. CAVANAGH. No, we are not surveying them on that question.

Mr. POMEROY. Perhaps after the tax year we could. It would be very interesting to see what kind of commercial activity is taking place.

Mr. CAVANAGH. Yes, Mr. Congressman, yes. Thank you.

Chairman HOUGHTON. There are only two of us here, if you want to continue asking the questions.

Mr. POMEROY. I think I pretty well got through it. I am interested in when the Commissioner said there is no express or implicit endorsement of products, the fact that there is a public-private partnership and you can access these vendors through the IRS Web site leaves me a little concerned that there may be an implicit statement by the IRS that these are appropriate products, and yet there does not seem to be an active review of whether the products are indeed appropriate. So, maybe we can install that going forward.

Mr. CAVANAGH. Congressman, but I would just note these companies are not vendors to the Federal Government. This is the www.irs.gov Web site. These companies are not contracting with the—through the IRS to do anything. So, vendors—that is not the relationship they have.

Mr. POMEROY. If I refer someone to someone else, I want to make sure that what they are selling is legit, and I think the same is true about the United States.

Mr. CAVANAGH. Sure.

Mr. POMEROY. If we refer we want to feel good about the product sold. By the way, I believe absolutely there are appropriate business opportunities for companies providing a service for products that taxpayers need. So, I don't impugn this. This isn't something—a marketplace that I think is judged guilty before proven innocent. I think it is a fine opportunity. I just want to know what activity is taking place in this marketplace. Thank you very much.

Chairman HOUGHTON. I think that is about all. The only other question I might have is about the EITC and those people who were involved in that, how do you reach them?

Mr. CAVANAGH. Well, Mr. Chairman, they are provided—there are a number of offers that would cover them and would cover the—those schedules, and so that is certainly included in the program. Absolutely.

Chairman HOUGHTON. All right.

Mr. CAVANAGH. Even as I think—as I saw here today the IRS was actually showing some the screens that the IRS has developed for information for EITC. So, that is absolutely an area that is—that is available as part of this Free File Alliance, Mr. Chairman.

Chairman HOUGHTON. Okay. Well, thank you very much. I am sorry this has been sort of a truncated type of thing, but we are victims of the flow of votes. So, thank you very much gentlemen for being with us. Now, Ms. Olson, if you could step up here, and we will see what we can do.

Ms. Olson, what I thought we would do is if you could give your testimony, and that would fit into our timeframe, then we will break, and then we will come back for questions afterward. Is that all right with you?

Ms. OLSON. That sounds wonderful, sir.

Chairman HOUGHTON. All right. Let me give you a chance to pour yourself a little water. Thank you very much for being so patient here.

Ms. OLSON. Oh sure.

Chairman HOUGHTON. Thanks again, gentlemen, for being part of this program. All right. Ms. Olson, who is the NTA of the Internal Revenue Service. Ms. Olson, we are delighted to have you here again.

**STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER
ADVOCATE, INTERNAL REVENUE SERVICE**

Ms. OLSON. Thank you. Okay. Mr. Chairman and Members of the Committee, thank you for inviting me to appear before you today to discuss my 2002 annual report to Congress. I appreciate your and the Committee's interest in the Taxpayer Advocate Service (TAS) and your work on tax simplification and taxpayer rights. I also wish to acknowledge here the efforts and talents of the many TAS employees who contributed to this report.

Last year I came before you to discuss some of our legislative recommendations for tax simplification, most notably the uniform definition of a qualifying child and the alternative minimum tax. This year we focus on the difficulty facing the IRS to fairly administer an enormous tax system while respecting taxpayer rights and providing customer service. The size and scope of the U.S. tax system makes achieving this balance a challenge.

Our theme this year is taxpayer rights. Taxpayer rights includes the taxpayer's right to expect to be treated promptly and courteously and to be provided accurate information, the right to receive adequate notice of any disagreement the IRS has with the taxpayer and the reasons for that disagreement, and the right to an adequate opportunity to dispute the IRS position before the taxpayer is required to pay any additional tax. These rights must be available to the taxpayer without causing the taxpayer undue burden in obtaining them. We are, after all, asking taxpayers to voluntarily pay over their taxes to us. We should not make it difficult for them to do so.

I believe that the next serious challenge to tax administration in the 21st century will not revolve around the balance between enforcement and taxpayer rights or customer service. Rather it will involve the balance between taxpayer rights, including customer service, and the drive toward efficiencies as a consequence of the sheer size and complexity of the U.S. tax system.

Over and over in the report's Most Serious Problems section, we highlight the difficult choices the IRS must make in its struggle to

provide taxpayers with the services they are requesting. Take offer in compromise, for example. We understand the basis for the Service's decision to centralize the processing of offers; however, we believe that centralizing offers does not mean that offers should be rejected without contact or discussion with the taxpayer. It may be with a phone call that some apparently unacceptable offers might turn into valid ones. There might be some vital information or some special circumstance left off the form, or with one follow-up phone call the taxpayer might be willing to enter into an installment agreement. Thus the taxpayer might not get the offer he or she wants, but he will get closure of some sort and a fresh start toward compliance. Yet direct phone contact with the taxpayers is the exception, not the norm, in centralized sites.

This emphasis on efficient processing of offers can lead to rework of the case by Appeals or the Taxpayer Advocate Service or, more importantly, to a lost opportunity to collect the tax. The IRS simply does not know what happens to offers after they are rejected. We do not know if we collect another dime on those rejected offers. Moreover, the program's own quality measures indicate that much can be done to improve the IRS's computation of the taxpayer's ability to pay or the correct offer amount.

In addition to the right to communicate with the IRS, the taxpayer has the right to be advised clearly and specifically about any proposed changes on his or her income tax return. For example, under math error authority, the IRS sends a notice to the taxpayer telling him that it has changed the tax due on the taxpayer's return. Unless the taxpayer timely requests an abatement of tax, the taxpayer cannot petition the U.S. Tax Court, which is the only forum in which a taxpayer can litigate a tax before it is assessed and becomes collectible. When Congress expanded math error authority in 1976, it clearly told the IRS to send taxpayers detailed, itemized, line-by-line explanations of the error so that taxpayers could timely respond with an abatement request. Yet math error notices today do not set out the adjustments line by line, and a sample of tax cases indicates that taxpayers do not know what is being adjusted and cannot reach someone in the IRS to explain the adjustment of the item, so they miss the opportunity to request abatement.

In 2001, Congress expanded math error authority, effective in 2004, to the use of the Federal Case Registry of Child Support Orders. This 2001 expansion applies math error authority to a question that is inherently factual and not ascertainable from the face of the tax return. It is our recommendation that Congress repeal the expansion of math error authority it enacted in 2001 and limit expansion of math error to quantitative, not qualitative, items.

In addition to math error authority, we have identified several key legislative recommendations in our reports, including the tax treatment of attorneys' fees in nonphysical personal injury cases and a system of registering, testing and certifying Federal income tax return preparers who are not already attorneys, certified public accountants or enrolled agents.

We are also proposing that a husband and wife who jointly own an unincorporated business and who file a joint Federal income tax return be permitted to elect out of the partnership provisions of the

Code and instead file a joint sole proprietorship or farm schedule and report each spouse's share of self-employment income.

We submit a proposal relating to the taxation of children's income, also known as the kiddie tax. This proposal goes to tax simplification and the reduction of taxpayer burden. As you know, if children under 14 have more than \$1,500 in unearned income, their tax must be computed at the parent's top marginal rate. Further, the parent can elect to include the child's unearned income on his or her return. Because these options lead to different tax results, a parent must calculate three returns in order to determine what is the best tax outcome. This process must be repeated for each additional child. Add to this the possibility of triggering a child's alternative minimum tax, and the difficulty of obtaining tax information from an estranged spouse, and you have a needlessly complex provision.

We propose that the calculation of tax on children's income be severed from the parents' tax computation or tax rate. The concern that taxpayers might shift income-producing assets to children and thereby take advantage of lower tax rates can be addressed by establishing an appropriate tax rate on the children's income.

In the interest of simplification, we also propose that Congress establish a set standard deduction for dependents rather than the current floating deduction amount.

Our last proposal addresses the operation of the Office of Taxpayer Advocate. We are recommending six revisions to our authorizing statute. All of these revisions derive from the fundamental premise reaffirmed in 1998 that the Office of the Taxpayer Advocate must be independent, and yet function within the IRS.

We first propose that the NTA be authorized to appoint a counsel who shall report directly to the Advocate and advise her on matters pertaining to taxpayer rights.

Chairman HOUGHTON. Ms. Olson, can I just interrupt a minute? I am going to have to go and vote, and if you wouldn't mind, we will vote fast, and then come right back. So, you can finish your testimony, and we will have the questions.

Ms. OLSON. Thank you.

Chairman HOUGHTON. Thank you for your forbearance.

Mr. PORTMAN. [Presiding.] Ms. Olson, a second welcome to the Subcommittee. I am glad to be with you. We have been tag-teaming this afternoon, as you know. I understand you had managed to get through some, but not all, of your oral testimony. If you would be so kind to continue that, Chairman Houghton and other Members should be returning shortly.

Ms. OLSON. All right. Let me find my place.

Our last proposal addresses the operation of the Office of the Taxpayer Advocate. We are recommending six revisions to our authorizing statute. All of these recommendations derive from the fundamental premise reaffirmed in 1998 that the Office of the Taxpayer Advocate must be independent, and yet function within the IRS.

We first propose that the NTA be authorized to appoint a counsel to the NTA who shall report directly to the Advocate and advise her on matters pertaining to taxpayer rights, tax administration and the Office of the Taxpayer Advocate.

Currently the NTA receives advice from a special counsel who reports directly to the Chief Counsel of the IRS. Given the unique role of the NTA to take positions that may be different from the official position of the IRS, there are times when this reporting structure creates a serious conflict of interest and limits the Advocate's access to independent legal advice.

We believe it is important to maintain the counsel to the Advocate's current ability to participate in the day-to-day development of guidance and regulation. We also believe it is important that the TAS continue to receive its legal advice on substantive tax law matters in specific cases from the IRS counsel. However, and finally, we believe that the conflict of interest on taxpayer rights and tax administration would warrant independent advice from a counsel that directly reports to the NTA.

We also propose that the Taxpayer Advocate Directive, which is currently delegated to the Advocate by the Commissioner, and which authorizes her to act on behalf of groups of taxpayers or taxpayers at large, be codified to ensure that it cannot be revoked.

We also propose that the definition of "significant hardship," which grants taxpayers access to TAS, be expanded to explicitly include impairment of taxpayer rights as a grounds for issuance of a Taxpayer Assistance Order or Taxpayer Advocate Directive.

Finally, we make some recommendations about the ability of and discretion of the Taxpayer Advocate Service to hold taxpayer communications confidential both from the IRS and in Federal courts.

I would like to conclude by acknowledging again the support your Committee has shown for my office and indeed the entire IRS. I know that the key subjects of this year's report, taxpayer rights and making the system simpler and more accessible so it is easier for taxpayers to comply with their tax obligations, are of special interest to this Committee. I hope our report has been of some assistance to your oversight duties.

Thank you for this opportunity. I also request permission at this time to submit a written statement for the record.

[The prepared statement of Ms. Olson follows:]

Statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service

Mr. Chairman and Members of the Committee, thank you for inviting me to appear before you today to discuss my 2002 Annual Report to Congress. I appreciate your and the Committee's interest in the Taxpayer Advocate Service and your work on tax simplification and taxpayer rights. I also wish to acknowledge the efforts and talents of the many Taxpayer Advocate Service employees who contributed to this Report.

Last year I came before you to discuss some of our legislative recommendations, most notably the uniform definition of a qualifying child and the alternative minimum tax. Our focus was on tax simplification. This year, we focus on the difficulty facing the IRS to fairly administer an enormous tax system. Combined with the complexity of the tax law—well, one can easily declare this task impossible. And yet, 98,000 employees each day show up to work, willing to take on this thankless job and do the best they can at it. Their efforts are obviously the reason why the Federal tax system runs as well as it does, despite all the challenges it faces.

The theme of this year's report is taxpayer rights. We do not use this term narrowly. Although clearly the concepts of sufficient notice and due process are integral to taxpayer rights, in this year's report we focused on a broader definition—one that looks at the essential contract between the government, as represented by its tax administration agency, and the taxpayer.

The U.S. tax system is, in fact, a voluntary tax system. Although people may joke about this, we rely on taxpayers to voluntarily file their tax returns and report the correct income and deductions and credits and tax. We ask employers to voluntarily submit the earnings and withholdings of their employees, and we ask the self-employed to voluntarily report revenue and expenses. And we ask everyone to voluntarily pay their correct share of the tax burden. Certainly, in some instances the IRS must take additional steps to secure this information or payment, but the compliance and enforcement functions of the IRS are only two of many aspects of tax administration.

The recognition and protection of a taxpayer's rights is a necessary and quite possibly paramount element of a voluntary tax system. By taxpayer rights, I mean the taxpayer's right to expect to be treated promptly and courteously and to be provided accurate information; the right to receive adequate notice of any disagreement the tax agency has with the taxpayer's return or position and the grounds for that disagreement; and the right to an adequate opportunity to dispute the tax agency's position before the taxpayer is required to pay any additional tax. These rights must be available to the taxpayer without causing the taxpayer undue burden in obtaining them. We are, after all, asking taxpayers to voluntarily pay over their taxes to us. We should not make it difficult for them to do so.

I believe that the next serious challenge to tax administration in the 21st century will NOT revolve around the balance between enforcement and taxpayer rights or customer service. Rather, it will involve the balance between taxpayer rights, including customer service, and the drive toward efficiencies as a consequence of the sheer size and complexity of the U.S. tax system.

Right now, the IRS is trying to identify when taxpayers should be spoken with in person, when they can receive recorded answers to questions, when they can be asked to leave a message and receive a return call. It is trying to determine what should be the core services delivered at "Taxpayer Assistance Centers," formerly called "walk-in sites." It is also trying to streamline processing of certain offers in compromise, correspondence audits of underreporter amounts and the earned income tax credit, and even the collection of certain tax debts through the use of private collection agencies.

Taxpayers and practitioners, on the other hand, complain of not being able to reach the IRS by phone—they cannot find the appropriate person to speak with or identify the management chain of command, or they leave messages that are not returned. They miss the geographic footprint of the IRS and they are unable to identify an IRS employee's job duties merely from that person's job title. Thus, we identify the top problem of taxpayers (and IRS employees, I might add) as that of merely navigating the IRS.

Over and over, in the Report's Top 20 problems section, we highlight the difficult choices the IRS must make in its struggle to provide taxpayers with the services they are requesting. Take offer in compromise, for example. This is a program in which the Office of the Taxpayer Advocate has been very active. We agree with the IRS that having Revenue Officers work the vast majority of offers, which present very simple situations, would be an inefficient use of very valuable resources. The expertise of Revenue Officers should be reserved for those offers that present difficult questions of valuation or other specific circumstances. We also understand the basis for the Service's decision to centralize the processing of offers, and my office and I are working with the IRS to improve that aspect of the program.

However, we believe that centralizing offers does not mean that offers should be processed without contact or discussion with the taxpayer. We understand that approximately 14 percent of submitted offers are returned to the taxpayer because the taxpayer's own financial calculation shows that he or she can fully pay the tax and does not need a compromise. Yet it may be, with a phone call, that some of these offers might turn into a valid offer—there might be some vital information or some special circumstance left off the form. Or, with one follow-up phone call, the taxpayer might be willing to enter into an installment agreement. Thus the taxpayer might not get the offer he or she wanted, but he will get closure of some sort, and a fresh start toward compliance. Yet direct phone contact with the taxpayer is the exception, not the norm, in centralized sites.

This emphasis on "efficient" processing of offers can lead to re-work of the case by Appeals or the Taxpayer Advocate Service, or, more importantly, to a lost opportunity to collect tax. The IRS simply does not know what happens to offers after they are rejected. We do not know if we collect another dime on those taxpayer accounts. Moreover, the program's own quality measures indicate that much can be done to improve the IRS's computation of the taxpayer's ability to pay, or the correct offer amount.

In our report we identify what we believe is a serious taxpayer rights issue—the IRS’s increasing use of a notice called a “combination letter,” which combines into one letter the notice of the Service’s proposed decision as well as notice of the taxpayer’s appeal rights. This “combination letter” pops up in the context of both offers in compromise and the earned income tax credit. For most other situations where a taxpayer is offered administrative appeal rights, including audits, the taxpayer receives two separate letters—one setting forth the proposed change and offering an opportunity to present more information, and the other outlining the IRS’s decision and explaining appeal rights. In the EITC “combo” letter, however, the IRS invites the taxpayer to send in additional information if he or she disagrees with the IRS’s proposed position. At the same time, the taxpayer is advised that he has a right to appeal, which is explained in an enclosed publication. Yet, that enclosed publication refers the taxpayer back to the letter for information on how to request an administrative appeal.

We simply do not believe that the “combo letter” format adequately advises the taxpayer of his or her right to an administrative appeal. It is poor customer service, leads to rework as audit reconsiderations and refund claims, and imposes an undue burden on taxpayers—all in the name of efficiency and minimizing resources.

In addition to the taxpayer’s right to be advised, clearly and specifically, about his or her administrative appeal rights, we believe the taxpayer has the right to be advised, clearly and specifically, about any proposed changes on his or her income tax return. As you know, the IRS has the authority under section 6213 to summarize assess mathematical and clerical errors that a taxpayer might make on his or her return. These errors include errors in addition, switching the digits on a Social Security number, or transcribing the wrong number from one form to another. If the taxpayer does not agree with the IRS about the adjustment, then the taxpayer must write the IRS within 60 days and ask it to abate the tax. If the taxpayer misses the 60 days, the IRS begins collection, and the taxpayer must make a refund claim. The taxpayer loses the ability to request an administrative appeal or the ability to go to the United States Tax Court, which is the only forum in which a taxpayer can litigate a tax before it is assessed and becomes collectible.

When Congress expanded the summary assessment authority in 1976 to clerical as well as math errors, it clearly directed the IRS to send taxpayers detailed, itemized, line-by-line explanations of the math or clerical error, so that taxpayers could timely respond with an appropriate abatement request. Yet math error notices today do not set out the adjustments line-by-line, and a sample of Taxpayer Advocate Service cases indicates that taxpayers do not know what is being adjusted and cannot reach someone in the IRS to explain the adjustment to them, so they miss their opportunity to request abatement.

Today, in the interests of efficiency and driven by concerns about EITC compliance, Congress has expanded math error authority to include matching information against external databases, despite Congress’s original concern that the authority should only be used where the error and inconsistency is apparent from the face of the return. In most of these expanded provisions, the correct answer is quantitative and not based on facts and circumstances, and the external database is highly reliable. However, in 2001, Congress expanded math error authority, effective in 2004, to the use of the Federal Case Registry of Child Support Orders. I have grave reservations about the currency and adequacy of the FCR’s data, but these concerns will be expressed in a report to be issued by the Treasury Department, in consultation with my office. My point today is that this 2001 expansion applies math error authority to a question that is inherently factual—whether a child lived with a taxpayer for more than half the year. I do not believe this information can accurately be determined from the face of the return, nor from any existing database. It relies on the specific facts and circumstances of a taxpayer’s situation, it is a qualitative—not quantitative—analysis, and as such is not the proper subject of a summary assessment, one that can result in the taxpayer losing the opportunity to petition the Tax Court.

Thus it is our recommendation that Congress repeal the expansion of math error authority it enacted in 2001 and impose certain requirements for any proposed expansion of math error authority—namely, that it apply only in those situations where inconsistencies can be determined from the face of the return, where items or schedules are omitted from the return, and where numerical or quantitative items are reported on the return and can be verified by a government entity that issues or calculates those items. We believe this approach to summary math error authority, coupled with clear and understandable explanations of math error adjustments, recognizes the IRS’s need to process information expeditiously without violating a taxpayer’s right to deficiency procedures in disputes of a factual nature.

In addition to math error authority, we have identified several key legislative recommendations in our report, including the tax treatment of attorney fees in non-physical personal injury cases, which results in significantly different tax treatment of Federal taxpayers depending on the underlying State law. We also propose a system of registering, testing, and certifying Federal income tax return preparers who are not already attorneys, CPAs, or enrolled agents. Our proposal is comprehensive and, we believe, does not require the expenditure of significant resources once the registration system is established.

We submit a proposal relating to the taxation of children's income—also known as the “kiddie tax.” This proposal goes to tax simplification and the reduction of taxpayer burden. As you know, if children under 14 have more than \$1,500 in unearned income, their tax must be computed at the parent's top marginal tax rate. Further, the parent can elect to include the child's unearned income on his or her return. Because these options lead to different tax results, a parent must calculate three returns in order to determine what is the best tax outcome. This process must be repeated for each additional child. Add to this the possibility of triggering a child's alternative minimum tax liability, or the difficulty of obtaining tax information from an estranged spouse, and you have a needlessly complex provision.

We propose that the calculation of tax on children's income be severed from the parent's tax computation or tax rate. The concern that taxpayers might shift income-producing assets to children and thereby take advantage of lower tax rates can be addressed by establishing an appropriate tax rate on the children's income. In a related matter, we note that the dependent's standard deduction is the only deduction that is not a set, flat amount. A dependent's standard deduction can be any number between \$750 and the single standard deduction amount. In the interests of simplification, we propose that Congress establish a set standard deduction for dependents.

As another simplification measure, we have suggested that a husband and wife who jointly own an unincorporated business and who file a joint Federal income tax return be permitted to elect out of the partnership provisions of the Code and instead file a “joint” sole proprietorship or farm schedule and report each spouse's share of self-employment income. Under today's law, a husband and wife jointly owning and operating an unincorporated business—say a dairy farm or small shop or even pet-sitting businesses—should file a partnership return. In practice, most couples merely report the business' income as a sole proprietorship, with only one member of the couple receiving credit for Social Security and Medicare purposes. This can lead to disastrous consequences if the uncovered spouse becomes disabled or dies. Because 97 percent of all sole proprietorship and farm schedules show income below the Social Security wage cap and because we propose to make this provision elective in any event, no couple would experience a tax increase yet many would clearly benefit from Social Security and Medicare eligibility. This proposal clarifies and simplifies the status of husband and wife co-owned businesses and ensures appropriate Social Security and Medicare coverage for the working couple.

One of our proposals was actually enacted and later repealed, but we think it is a good idea so we are proposing it again. Today, under section 3402(i)(1), taxpayers can increase their withholding from paychecks by a specified amount. They cannot, however, decrease their withholding by specified amounts. The only way to decrease withholding is by claiming additional withholding allowances, which requires a complex set of calculations on various schedules or worksheets. We propose that taxpayers be able to decrease the amount of their withholding by discrete amounts, just as they can increase their withholding. This approach reflects the way taxpayers actually think about their withholding and, in many instances, eliminates the burden of having to fill out schedules and forms.

Our last proposal addresses the operation of the Office of the Taxpayer Advocate. We are recommending six revisions to our authorizing statute, five of which I will discuss today. Our proposal for amicus brief authority I will leave to another time. All of these recommendations derive from the fundamental premise, reaffirmed in 1998, that the Office of the Taxpayer Advocate must be independent and yet function within the IRS. These recommendations attempt to strengthen that independence while preserving the Advocate's internal placement. These proposals also attempt to strengthen the Advocate's ability to protect taxpayer rights.

We first propose that the National Taxpayer Advocate be authorized to appoint a Counsel to the National Taxpayer Advocate, who shall report directly to the Advocate and advise her on matters pertaining to taxpayer rights, tax administration, and the Office of the Taxpayer Advocate. Currently, the Advocate receives advice from a special counsel, who reports directly to the Chief Counsel of the IRS. Given the unique role of the National Taxpayer Advocate to take a position that may be different from the official position of the IRS, there are times when this reporting

structure creates a serious conflict of interest and limits the Advocate's access to legal advice. We believe it is important to maintain the Counsel to the Advocate's current ability to participate in the day-to-day development of guidance and regulations. We also believe that it is important that the Taxpayer Advocate Service continue to receive its legal advice on substantive tax law matters in specific taxpayer cases from the Office of Chief Counsel. Thus, this proposal provides the Office of the Taxpayer Advocate with dedicated legal counsel on matters specifically related to its statutory mission, namely taxpayer rights in the context of tax administration.

The other proposals flow from the recognition of our statutory mission. We propose that the Taxpayer Advocate Directive, currently delegated to the National Taxpayer Advocate, be codified to ensure that it cannot be revoked. The Taxpayer Advocate Directive grants the National Taxpayer Advocate the authority to direct the IRS to act or not act with respect to any program or action—actual or proposed—that may create a significant hardship for a group of taxpayers or for all taxpayers. We also propose that the definition of significant hardship—which grants taxpayers access to the Taxpayer Advocate Service—be expanded to explicitly include “impairment of taxpayer rights” as a grounds for issuance of a Taxpayer Assistance Order or a Taxpayer Advocate Directive.

Finally, we recommend that the provision relating to the discretion of the Local Taxpayer Advocate to not disclose to the rest of the IRS any information obtained from the taxpayer directly be amended to make clear that this discretion applies notwithstanding any other provision of the Code. This discretion applies except in clear instances of criminal acts or civil fraud. Our proposal clarifies the source of authority for the approach we have adopted. We also recommend that the confidentiality provisions of the Administrative Dispute Resolution Act with respect to compelling a “neutral” to testify be incorporated into IRC section 7803(c)(4). These provisions would require a judge to weigh whether the need for a Taxpayer Advocate Service employee's testimony outweighs the chilling effect such testimony might have on future taxpayers seeking our assistance. We believe this neutral, third party determination will provide some assurance to taxpayers that their conversations with the Taxpayer Advocate Service, absent some serious violation or need, will not be disclosed to the IRS or even in open court, unless necessary to resolve the taxpayer's problem.

I would like to conclude by acknowledging again the support your Committee has shown for the work of my office, and indeed the entire IRS. I know that the key subjects of this year's report—taxpayer rights and making the tax system simpler and more accessible so it is easier for taxpayers to comply—are of special interest to this Committee. I hope our report has been of some assistance to your oversight duties. Thank you for this opportunity to come before you to discuss these important matters.

Chairman HOUGHTON. [Presiding.] Absolutely. Thank you very much. You have done a wonderful job. We are honored to have you here. The fact that you have this job is really because of Mr. Portman and the structural work which he had done. So, I am indebted to him as always.

Anyway, at the end you talked about the confidentiality issue. Do you think that really is working, the ability to communicate to your office by taxpayers?

Ms. OLSON. We have not yet fully implemented the confidentiality provisions. We are beginning to, as our new database system goes online, which enables us to keep information confidential from the rest of the IRS. In talking to practitioners and taxpayers in some of our focus groups—we went out to six different focus groups during the last year—we found that regardless of income level or language facility, it mattered to taxpayers that they had someone independent inside the IRS to speak to and that they could tell us things. Most people think these things have to do with fraud or something like that, but they mainly have to do with personal matters. Taxpayers could tell us things that related to their problems, they could talk with us, and it wouldn't necessarily need to go to

the IRS. It was irrelevant in a way to the underlying tax law, but they wanted to have an ear in the IRS that they could speak to.

So, I think that that provision is very important. Our employees understand the importance of it.

We have tried to work with the IRS to convince them that we will be implementing this and not using it as a way to hide important information from the IRS, but rather to bring taxpayers into compliance and have them feel comfortable coming to us on touchy issues and coming into compliance with the Internal Revenue laws. I think confidentiality is vital to that.

Chairman HOUGHTON. All right. Well, I am always in awe of lawyers, but I wonder why you are adding a counsel to your staff at this particular time.

Ms. OLSON. We have had several issues in which my office has taken a different position from the direction in which the IRS has chosen to go. As you know, I do have the ability through the annual report to Congress and other means to take positions that are different from the Commissioner. I cannot override the Commissioner's decision, but I can be on the record about my position. It places the counsel that I currently have—who reports to Chief Counsel, who advises the Commissioner and would advise the Commissioner on his position—in sort of an untenable conflict position.

I would like to have sound advice if I am going to take a position. I don't want to be taking a position that is out of ignorance rather than sound principle or law.

Chairman HOUGHTON. Right. Well, just one final question for you, then I will ask Mr. Portman to question. Of all the recommendations you have made, what is the most important?

Ms. OLSON. Oh, dear. That is very difficult to answer because they are all so different. In terms of taxpayer rights, I think the math error authority recommendation is the most important. In terms of tax simplification, I think it is actually a toss-up between the children's income proposal and the husband and wife co-owned business proposal. I think both of them present simplification issues. Probably the children's income affects many more taxpayers than the husband and wife proposal.

Chairman HOUGHTON. Okay. Well, thank you very much.

Mr. Portman.

Mr. PORTMAN. Thank you, Mr. Chairman. Although you are inaccurate in saying that Ms. Olson got her job because of our work, you probably made her mad at me by saying that, because she has been in the middle of some very, very tough issues, but she has done well, and she has managed to do what we had hoped would happen in the legislation that went through this Subcommittee, which is to have a truly independent Taxpayer Advocate and someone who could give us an unvarnished view on not just Tax Code simplification, which you did well in your report last year, but also on tax law administration, which you have focused on more this year. That is extremely important to this Subcommittee and to our Committee because it gives us the ability to legislate with better information.

I want to focus on two things, if I could, quickly. One is the offer in compromise issue. You said that is the number 2 issue for you. There has been a lot of attention focused on that recently. I know

the oversight board met late January and discussed this issue at some length, and some practitioner groups have raised concerns with the offer program. On the other hand, I saw that Dale Hart was recently quoted in the Wall Street Journal, who is the Deputy Commissioner of the small business area and self-employed, saying he thought the offer and compromise program had turned the corner.

So, I am hearing sort of different perspectives on it. We added under the IRS Restructuring and Reform Act of 1998 (P.L. 105-206) another criteria. You could always do it if there is a question about liability or collectability, and we added this relatively broadly defined notion of effective tax administration. Has that created some of the problems, and where do you think the offer and compromise program is at this point?

Ms. OLSON. Well, first let me address why we put it as number 2, because if you look at it in the context of all the business that the IRS does, we only get 130,000 offers a year, and that is a pittance in terms of all the other work that we do. We put it as number 2 because it has been around for so long. In fact, 1868 is the first time it showed up in the U.S. Code, the authority for the revenue officer to compromise tax debts. We have felt that at least since 1992, the IRS hasn't gotten it right, so we thought maybe by giving a lot of attention to it and going carefully through what we thought were problems with the program, we could lay out some of the adjustments that needed to be made.

Since we started, maybe since 2001, we have had an analyst dedicated entirely to that program, and much to the Small Business and Self Employed Division's great credit, they have worked closely with us, and I think it is a successful partnership.

I agree with Deputy Commissioner Hart that the program has turned the corner. I think that I can live with centralization, but there are things that we need to do to make the centralized sites more responsive to taxpayers. It does take some adjustment, but if we continue to work along some of the lines that we have identified in the report, we will finally get there.

Now, effective tax administration—there were three grounds—economic hardship, equity and public policy. I think the IRS has understood economic hardship pretty well, but I think on the grounds of equity and public policy, we have had some difficulty in trying to decide what those words mean. What we came up with, what Treasury announced through its recent regulation that was issued this past summer was, on those two categories, equity and public policy, we want taxpayers, if there is some reason other than financial inability to pay, or you don't think you actually owe the tax, to come in to us and tell us why it is that you should be cut a break as opposed to all the other taxpayers in the world who pay their taxes. What is so different about your facts and circumstances?

We would take a look at those factors, rather than giving a list to which somebody could say, well, you are not on the list, so we are not going to listen to you. We would see what came in. People had to answer that first question, though: What is so special about you? Can you look at your neighbor and say to them with a straight face, I am going to get a break, but you have to pay?

Mr. PORTMAN. It almost becomes a fact and circumstances test, which again, in the legislation, economic hardship is easier, it is closer actually to doubt as to collectability, which is already in the criteria. It is true that equity probably comes down to a facts and circumstances, more subjective test. You are saying you have flexibility to do that. You feel like you are turning the corner.

Just for those who are listening and might not understand what we are talking about, this is when a taxpayer does not have to pay the full amount, the full liability owed. The process of negotiating with the IRS gives them an opportunity to settle for less than the full amount, which is a very important way to clear the decks and to help a lot of taxpayers who do have some specific circumstances that make it difficult to pay.

I don't have another question, but I will say just briefly, Mr. Chairman, we appreciate what you do for our taxpayers; also what you do for us. Keep giving us those simplification ideas. Mr. Houghton has a bill on simplification that is very important. I have one, too. We take your ideas seriously, as you see in our legislation, and this notion of how to tax children, which is a huge simplification, is an example of what you need to keep giving us and working with us. So, thank you for your work.

Ms. OLSON. Thank you very much.

Chairman HOUGHTON. Thanks very much.

Ms. Tubbs Jones.

Ms. TUBBS JONES. I want to pick this Committee. I could be Chairman soon, right, if I just hang around. I will keep on moving over here. I am okay. Thanks. Hi, Ms. Olson. How are you?

Ms. OLSON. I am fine, thank you.

Ms. TUBBS JONES. I am trying to get up on this. I don't serve on this Subcommittee, but I am glad to be here. I was just looking at some questions I was going to ask you, and I lost my place. If you will just give me 1 second. Why don't you for one moment talk about something, anything you would like to talk about no one has asked you. Have you already been given that authority?

Ms. OLSON. Actually I thought one of the things I would like to talk about is our first problem, which is navigating the IRS. I wanted to tell a story. When the report came out, we issued a voice message to all IRS employees and told them that they could look at the report. I got back a lot of e-mails from IRS employees from all over the United States, and one e-mail that I got back was from a woman who said, I used to be—I was a revenue agent in the examination division before the reorganization, and people could always find me because if they knew that they were being audited, even if they didn't know my job title, they could look up "exam" in the phone book and find me. Today I am called small business self-employment technical analyst, branch 2, and how can someone find me?

I read that e-mail, and I just sort of slapped my forehead; naming conventions. We have made it so difficult for people to communicate with us through all of this reorganization by just simply removing common-sense names.

Ms. TUBBS JONES. What is your position with regard to the Free File, if I may ask?

Ms. OLSON. I think that free filing is an important service. I think that the products we have up there are excellent. I have expressed my concern during the development of the products and the consortium negotiations about the additional products that were present in the software. I do have a strong feeling that we should not be making available those products through a government Web site. I am concerned that the disclaimers are not adequate, in fact, to warn taxpayers, particularly when you look at the taxpayer population that is targeted for these products. If you look at their financial literacy levels, their ability to understand contracts, over and over and over again you see that these disclaimers may not be understood.

Ms. TUBBS JONES. That is an area that I was working on before I came to this Committee. I was on Financial Services, and the whole issue of predatory lending, and rent to own, and payday loans and all of those opportunities where people—you get to the people who are most vulnerable. I am not saying that there should not be the opportunity, I understand that subprime lending provides opportunities for those who may not be able to go in the prime market, but clearly I think there has to be some way that we can do a few more disclaimers or better notice in the area.

Let me see what else I would like to ask you. Talk to me for a moment if you have not already about the taxation of attorney fee awards, if you would.

Ms. OLSON. Well, what we discovered in looking at the case law, and this came up through our most litigated issues section, we found that there was a split in the circuits about the taxation of attorneys' fees in what is called nonphysical personal injury suits: race discrimination, sex discrimination, sexual harassment, age discrimination; and that in some circuits, depending on the underlying State law, the fees may be deductible above the line or below line. They trigger radically different tax results, including the triggering of the alternative minimum tax. In our report, we gave an example of a woman who ended up being a successful plaintiff and paying more in taxes and attorneys' fees than she won in the award. So, she came out in a negative amount. She would have been better off not prevailing.

So, we proposed several alternatives. The one that we liked was putting everything what we call above the line so that you don't trigger alternative minimum tax, basically netting out the attorneys' fees and making that uniform across the Nation and not dependent on underlying State law.

Ms. TUBBS JONES. Ms. Olson, I just ran out of time. I am looking forward to have the opportunity to get to know you better and working with you, and hopefully providing some additional information to the constituents, my constituents in the 11th Congressional District of Ohio. I thank you very much for your testimony, though I missed some of it.

Chairman HOUGHTON. Thanks, Ms. Tubbs Jones.

Mr. Pomeroy.^t

Mr. POMEROY. Thank you, Mr. Chairman.

Ms. Olson, I suppose right up next to the Commissioner we put the Taxpayer Advocate as one of the most important if not the most important position in the IRS. It was established with bipar-

tisan support. We commend you for your efforts on behalf of taxpayers. This service is their service, and we want to make certain that it is fair and equitable in its delivery of services to the American public.

Several things I want to talk to you about, but time is short. Let me begin by products. It would seem to me as though there is a substantial contribution by the private partners in this private-public partnership delivering free e-filing. Obviously they are interested in participating with the hope of some business opportunity. Does that ring off the bat strike you as inappropriate or so far so good depending on what they are selling?

Ms. OLSON. Right. I think that is an appropriate arrangement, I do.

Mr. POMEROY. So, you think there needs to be within the service some due diligence as to appropriateness of services rendered?

Ms. OLSON. I would like us to develop standards and really address this issue, yes, I would.

Mr. POMEROY. It seems to me incongruous and unacceptable to have a very thorough due diligence in terms of whether they have got the security in place, whether they have the technical competence to get it all figured right—undoubtedly give each of the partners a very thorough review relative to the technical components of their ability to deliver e-filing. Then to let them offer caveat emptor whatever they may hope to try to sell, that just doesn't cut it.

We ought to be able to find some happy medium in terms of appropriate review, again not making the service a regulator as well as a tax collector, but making sure that those things sold by its private sector partners pass the smell test to market suitability. Is that how you would see it?

Ms. OLSON. I would agree with that, and I would also say that there needs to be appropriate disclaimers directed to the reading level and the literacy level of the target audience. We have targeted the Free File to low-income taxpayers.

Mr. POMEROY. Does the Advisory Committee look at this sort of thing?

Ms. OLSON. The ETAAC?

Mr. POMEROY. Yeah.

Ms. OLSON. I know that they have considered this issue. That would be an appropriate place, I would think, to start to develop some recommendations.

Mr. POMEROY. I will direct that inquiry to them. Thank you for that.

We received from your counterpart in Fargo, North Dakota, a really fabulous idea that we want to advance, and that is relative to filing a husband/wife return on a farm, presently, as I understand it, it has to be either in partnership, which involves some taxpayer complexity, or basically between the two of them they have to allocate all of the income to one, usually, of course, the male.

Ms. OLSON. Legally they are supposed to file a partnership return.

Mr. POMEROY. Within this partnership return is the revenue attributed to one spouse or the other, or how does that work?

Ms. OLSON. In a partnership return they can attribute it to the extent that they agree. It is completely open. What we find in practice is that most husband and wife co-owned businesses that aren't incorporated tend to put all the income in one person's name and report it on a sole proprietorship schedule or in the farming business, on a Schedule F. So, what ends up happening is that the other spouse doesn't have any income reported to them, and the consequence of that is the spouse doesn't get any Social Security or Medicare credits.

Mr. POMEROY. Precisely. So, what appears to be, while the easy route in terms of filing the tax return in a given year, becomes a pattern, and the income is attributed just to one spouse.

Ms. OLSON. Correct.

Mr. POMEROY. Down the road that might mean the other spouse, should this marriage end by divorce or death, does not have the 10 quarters required for purposes of qualifying for Social Security; is that right?

Ms. OLSON. That is correct.

Mr. POMEROY. The recommendation from the Fargo Taxpayer Advocate is that this needs to be attended to in ways that family farmers can avail themselves of simpler tax filings, but still allocate the income; is that correct?

Ms. OLSON. Right. We recommended that you could use a Schedule C, for sole proprietorships, or the Schedule F, for farms and report all the income on one form, but just add two lines to the form where you could allocate between the husband and wife at the very bottom of the form what percentage of the net profit or loss is each person's.

Mr. POMEROY. The Chairman and I each represent farm families, and this is an idea we think is very interesting. We will be looking to see whether or not we want to advance a joint bipartisan legislative proposal directly as a result of your Fargo, North Dakota, Taxpayer Advocate. I am very proud of the job—

Ms. OLSON. I am very proud of that person, too.

Mr. POMEROY. Thank you very much.

Chairman HOUGHTON. Thank you. Well, I just have one other question. You obviously have got a very important job now between Mr. Rossotti going in and—going out and Mr. Everson coming in and Mr. Wenzel leaving, lots on your shoulders.

Let me ask you a question. How many people read your report?

Ms. OLSON. Well, I know—

Chairman HOUGHTON. Or even open it?

Ms. OLSON. Well, let me just say that I know that Commissioner-designate Everson has read it; not all of it, but I know that he has read parts of it. It is surprising how many people read it if you judge by my e-mail and my voice messages and my mail. We would like more people to read it because we believe that particularly this year we have shown a spotlight on the way that the IRS works, and it should actually make taxpayers feel very good as they read through the top 20 problems—and they see how we identify a problem and the IRS responds—how much the IRS really is doing about the problems that it faces.

So, much of what is troubling to the IRS is just a result of the complexity of the tax system both in terms of the law and the proc-

essing, the Administration, and they are doing an enormous amount. The report really shows that, and citizens should feel good about it.

Chairman HOUGHTON. One of my hot buttons has always been the issue of complexity of the Code, and we sit here and we pass legislation, we think it is for the good of the country, and yet it horribly complicates the Code. So, I think it might be helpful in further meetings that we have that you can sort of keep us up to date with a scorecard on what we have done, because it is a two-way street here.

I have one final question. You have this fine report, and there is a conclusion, section 1 of page 4. What would you like the conclusion to say next year?

Ms. OLSON. I will have to look at what the conclusion says this year.

I think I would like to see the IRS having made substantial progress in the five areas that I outlined in the preface underlying taxpayer rights; the concept of access to information, to the IRS, to the Taxpayer Advocate Service, to representation from low-income taxpayer clinic programs, which just came under my jurisdiction, and free tax preparation. We are along the way. I really want to see some progress that we can report on, and particularly on that number 1 issue, navigating the IRS. It is in the social contract between the IRS, the tax administration system, and its taxpayers. We have to become accessible to them, or else why should they ever pay their taxes if they can't reach us to talk about their problems? I want more progress on that. That is really why we made it number 1.

I would like to conclude that we had made progress. There are steps to go, but we have made progress.

Chairman HOUGHTON. All right. Well, thank you. You are a credit to all of us, and thanks so much for your testimony. Good luck to you.

Ms. OLSON. Thank you, sir.

[Whereupon, at 4:50 p.m., the hearing was adjourned.]

[Submission for the record follows:]

Statement of Grover Norquist, President, Americans for Tax Reform

On July 31, 2002, the Bush Administration announced a Public-Private Partnership with the high technology industry to increase the availability of free online tax preparation and e-filing services to American taxpayers. On October 31, 2002, then-Commissioner of Internal Revenue, Charles Rossotti, signed this historic agreement in Washington. This innovative initiative is a constructive and thoughtful resolution of a long-standing public policy problem.

But it's only the first step. What happened in Washington needs to be replicated in every State capital in the union. Here's why.

On multiple occasions over the past five years the Internal Revenue Service has proposed that it should provide electronic tax preparation and filing services to taxpayers. One year ago, the Office of Management and Budget revived the idea and pressed to move ahead. Fortunately, Congress has repeatedly objected to these attempts to have the Nation's tax collector take on the additional role of also acting as citizen's tax preparer.

While such an obvious conflict of interest has at times been advanced by some as representing a new "service to the citizen," it would in reality have been a significant and intrusive expansion of the role of government, and a major setback for the American principle of voluntary compliance in our tax system.

Worst of all, it would have served as a disguised revenue enhancement strategy—bracket creep through mission creep.

But while Congress rebuffed these attempts to expand the role of government at the Federal level, there were no similar checks and balances at the State level, and as a result over the last several years some 26 State revenue collection agencies instituted the very programs the Federal Government has so wisely shunned, and in the process the States collectively expended literally billions of taxpayer dollars to pay for the design, development and operation of these government-run online tax preparation systems.

Their national tax collectors union, the Federation of Tax Administrators (FTA), reported last year that all of these State online tax systems combined generated 800,000 tax returns in the last tax season. That's just 1% of State income tax returns, all at a staggering administrative cost. (With this kind of waste, it's little wonder that our State governments are now going broke.) So why do they press ahead with this effort? Indeed, why did they try in the first place?

We know that at least some State revenue agencies designed their online tax preparation systems with the intent of using them to increase revenue receipts from taxpayers, and actually financed the substantial cost of the systems from those projected new revenues. The Virginia Department of Revenue, for example, has boasted of their plans, in reports addressed to their Governor, bragging that their new \$125M "iFile" online tax preparation system would be financed from "increased tax revenues attributed to the successful implementation," and that the system would assist the tax agency in "selecting audits and ... performing focused, effective, and timely account collections."

Just last week, the *New Jersey Star-Ledger*, *The Los Angeles Times* and other newspapers across the Nation reported that State tax agencies across the Nation are using the modern tools of electronic data retrieval and examination to do exactly what the Virginia Department of Revenue described. The Executive Director of the national Federation of Tax Administrators (FTA), Harley Duncan, is quoted promoting the value of using "data mining" to deeply penetrate electronic taxpayer records, and how State revenue agencies are now using their modern computerized tools to dig through citizen data files of personal financial information.

"It amounts to combing through files that can tell you something about taxpayers," the FTA's Duncan explained. He went on to justify these new practices by his members in State tax agencies across the Nation, saying that "data mining isn't enough, in and of itself, to bring States through this particular (budget) crisis, but if you're ... looking for \$25 million to augment a program, and you can pick it up by better mining your tax base, that's significant."

This kind of intrusive surveillance, and surreptitious investigation of taxpayer records and personal financial information, is deeply disturbing, and is but the latest in the long, sorry history of abuses of taxpayers by government revenue collection agencies. However, this is not unexpected; indeed, it is just one of the dangers that has long been predicted from the conflict of interest created when tax collectors are put into the role of tax preparers.

The reality is that when a citizen prepares their taxes online in a State revenue agency computer system, every keystroke, correction, change and draft created in the course of preparing that tax return is automatically recorded and stored in the tax agency's data files. That is the basic nature of server-based online transactional technology. And when government unwisely decides to provide personal financial services to citizens, such as tax preparation, the dangers of this technology are suddenly very real.

In defending its desire to build these systems and begin preparing citizen's tax returns for them online, the State of California revenue bureaucrats actually had the temerity to tell the public that "(We) will always be beholden to the taxpayers and have the taxpayers' best interest at heart."

That is not reassuring, nor is it credible.

Back in a more sensible past, government tax agencies only received a citizen's final, completed return. And tax agencies only lawfully got their hands on a citizen's preliminary tax information and other personal financial data through official investigations, and by court order in civil and criminal proceedings. But not anymore.

If a citizen is foolish enough to prepare their tax return on a State revenue agency's online system, they are playing with fire, and, unwittingly, with potential self-incrimination. If our citizens use the online tax preparation systems provided and operated by State revenue agencies, they are effectively serving themselves up to be flagged for examination, investigation and audits.

The high risk of this threat to our citizenry is a prime example of why the Bush Administration well deserves the bipartisan support it has received for instituting its Public-Private Partnership solution, where those in need can get free online tax services, but from the private sector, instead of the government. Under this national solution, the IRS will still only receive a citizen's final, completed tax return. And

that's the way it should be in the voluntary compliance system we have in the United States.

It has been our consistent view at Americans for Tax Reform that changes in tax policy should be dealt with openly and with full public disclosure and debate. Bureaucratic ambitions for stealth tax increases—enabling government to grow and expand its mission without oversight or checks and balances—should never be permitted by policymakers under any circumstances. It is, in reality, a betrayal of the public trust.

Notwithstanding the vociferous advocacy of these programs by the Federation of Tax Administrators, as the preferred electronic weapon of choice for its nationwide membership of professional tax collectors, the fact is that the per-return cost of these government systems is astronomical, and, in the end, is serving only to provide employment security for tax bureaucrats. These initiatives are not “electronic government” or “citizen service”; they are electronic fraud and amount to nothing more than citizen deception.

It is little wonder, then, that this same national tax collectors union has tried mightily to protect its vested self-interests by going around to newspapers all over the United States attacking the Federal Free File Alliance initiative. However, the Bush Administration solution is so cost-effective and even-handed that it puts the lie to any justification for governments wasting public funds on creating their own online tax systems.

Some States know better than to pay heed to their tax bureaucrats’ self-interested ambitions, and are instead looking for better answers that maintain the integrity of their relationship with their citizens. After the Federal Free File Alliance Agreement was signed on October 31 last year, the States of New York, Massachusetts and Michigan had already replicated the Federal initiative and launched their own Free File Alliances by the following January.

But those States that do not choose this sensible approach are headed down a road to nowhere. This same folly of building government online tax systems has been attempted elsewhere, and with results similar to those we’ve seen in the U.S.—taxpayers shun them.

For example, in the United Kingdom, hundreds of millions of pounds have been incinerated on these same government online tax systems, but which collected only 75,000 tax returns last tax year (less than 1% of total returns, with much of the online filing done by panicked procrastinators) in a “service” that was riddled with errors, breakdowns and breaches of privacy and security. Polls released just this week in the United Kingdom have shown that 93% of Britons say they refuse to even consider using the government online tax system, citing risks relating to security, reliability and accuracy among other concerns. A similar system deployed by the Australian government has been used by only 3% of the taxpayers there.

The decision by the Bush Administration to ultimately reject this path is not only enlightened, but, most importantly, puts the best interest of the citizen ahead of that of the bureaucrat. The American taxpayer simply cannot afford the public waste of government investing hundreds of millions of dollars for bureaucratic featherbedding, duplicating the electronic tax systems already invented, developed and deployed by the private sector e-commerce industry, with services already available at low-cost and no-cost to taxpayers today. Whether tax bureaucrats would build or buy such systems and services is irrelevant. Either way, it would waste precious tax dollars on expansion of government into a mission that is a gross conflict of interest, and the taxpayer would end up paying the freight, coming and going.

The new Public-Private Partnership announced by the Administration is a precedent-setting innovation that chooses the consumer benefits of market competition instead of anti-competitive government expansion, and ensures protection of taxpayer privacy and taxpayer rights over the threat of government intrusion and conflict of interest.

The Administration’s voluntary agreement with industry costs the public treasury virtually nothing, and encourages continued private sector investment, competition and innovation, while encouraging the private sector to provide free services to those who truly need them. Congress has already legislatively endorsed the Administration’s policy direction. Now the national solution to this issue should be emulated by all of the Nation’s governors and State legislatures.

Asking taxpayers to trust the tax collector is ludicrous. Making them pay for such folly is unacceptable.

